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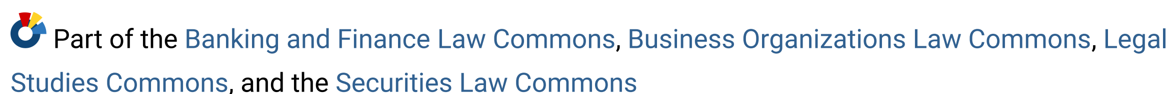
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The Self-Regulation of Investment Bankers

*Andrew F. Tuch**

ABSTRACT

As broker-dealers, investment bankers must register with the Financial Industry Regulatory Authority ("FINRA") and comply with its rules, including the requirement to "observe high standards of commercial honor and just and equitable principles of trade." As the self-regulatory body for broker-dealers, FINRA functions as the equivalent of the self-regulatory bodies governing other professionals, such as lawyers and accountants. Unlike the self-regulation of these professionals, however, the self-regulation of investment bankers has thus far attracted scant scholarly attention.

This Article evaluates the effectiveness of this self-regulatory system in deterring investment bankers' misconduct. Based on a hand-collected data set of every disciplinary matter by FINRA during the period from January 2008 (shortly after FINRA's formal organization) to June 2013, this Article shows that FINRA sanctions remarkably few investment bankers. Relying on this data, the Article argues that the current system of self-regulation underdeters investment bankers' misconduct. In addition, the burdens of the existing approach to self-regulation may well exceed its benefits. Other techniques for regulating bankers' conduct, including private and SEC enforcement, are unlikely to compensate for the weak deterrence force of self-regulation. Yet self-regulation offers distinct advantages over these other techniques, including the ability to impose more fine-grained rules. Therefore, although the current approach to self-regulation is failing, this Article argues that self-regulation must be retained and improved and considers ways of doing so.

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INTRODUCTION

Investment bankers—the "masters of the universe" in financial industry parlance[1]—are periodically admonished by the Delaware Court of Chancery when it adjudicates high-stakes merger and acquisition transactions. In 2011, for instance, investment bankers were disparaged in a highly publicized opinion for "secretly and selfishly manipulat[ing] the sale process to engineer a transaction that would permit [their firm] to obtain lucrative . . . fees."[2] The following year, a

[1] The quoted phrase is generally attributed to Tom Wolfe's iconic book, *The Bonfire of the Vanities*. *See* TOM WOLFE, THE BONFIRE OF THE VANITIES (1987).

[2] *In re* Del Monte Foods Co. S'holders Litig., 25 A.3d 813, 817 (Del. Ch. 2011).

prominent investment banker faced criticism for failing to disclose a material conflict of interest to his client, a failure the court described as "very troubling" and "tend[ing] to undercut the credibility of . . . the strategic advice he gave."[3] These are far from isolated instances of alleged improper behavior by investment bankers, and are consistent with popularly expressed concerns about investment bankers' conduct.[4]

Yet if one examines the *professional* background records of investment bankers adversely mentioned in Delaware judicial opinions, a disturbing pattern emerges: none are tainted by disciplinary actions.[5]

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3 *In re* El Paso Corp. S'holder Litig., 41 A.3d 432, 442 (Del. Ch. 2012).

4 *See, e.g.*, Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1283 (Del. 1988) (asserting that the investment banker involved had "violated every principle of fair dealing, and of the exacting role demanded of those entrusted with the conduct of an auction for the sale of corporate control [namely, investment bankers]"); *In re* Rural Metro Corp. Stockholders Litig., 88 A.3d 54, 100, 103 (Del. Ch. 2014) (describing as "egregious" an investment bank's failure to disclose to its client its "fevered efforts" to fund a third party's acquisition of its client, and condemning the investment bank's disclosure of its client's "inside information"); *In re* S. Peru Copper Corp. S'holder Derivative Litig., 52 A.3d 761, 801, 804 (Del. Ch. 2011) (disparaging an investment bank's conduct as lending credence to arguments that the sale process was an exercise in rationalization, and as not serving its client's interests "ideally"); *In re* Toys "R" Us, Inc. S'holder Litig., 877 A.2d 975, 1006 (Del. Ch. 2005) (criticizing investment bankers' conduct as "playing into already heightened suspicions about the ethics of investment banking firms"); *In re* Prime Hospitality, Inc. S'holders Litig., No. Civ.A. 652-N, 2005 WL 1138738, at *4 (Del. Ch. May 4, 2005) (reproving an investment banker's failure to disclose a potential conflict of interest).

As to more popularly expressed concerns, see 2 PARLIAMENTARY COMM'N ON BANKING STANDARDS, CHANGING BANKING FOR GOOD 99 (2013) [hereinafter UK PARLIAMENTARY BANKING REPORT], *available at* http://www.parliament.uk/business/committees/committees-a-z/joint-select/professional-standards-in-the-banking-industry/news/changing-banking-for-good-report/ ("[T]he world of investment banking may have seemed mysterious, even glamorous[;] . . . in recent times, shockingly poor standards and culture have been revealed."); SAMUEL L. HAYES ET AL., Competition in the Investment banking Industry 20 (1983) (referring to the investment banking industry's "long history of suspicion and questionable behavior"); JOHN N. REYNOLDS & EDMUND NEWELL, ETHICS IN INVESTMENT BANKING 2 (2011) ("Investment banks have been accused of major ethical failings . . . . Investment banking has become subject to an unprecedented level of public and political opprobrium and scrutiny."); *id.* at 160 ("Investment banks and investment banking culture have come under considerable scrutiny and criticism during the financial crisis."); JOSEPH E. STIGLITZ, THE ROARING NINETIES: A NEW HISTORY OF THE WORLD'S MOST PROSPEROUS DECADE 157–58 (2003) (discussing conduct of investment banking firms that brought them "into the worst disrepute" and suggesting that "money triumphed over morals"); *id.* at 167 ("[A]ll too often, [investment banking firms] trafficked in distorted or inaccurate information, and participated in schemes that helped others distort the information they provided and enriched others at shareholders' expense."); *Who Wants to Be an Investment Banker?*, ECONOMIST (Nov. 21, 2012), http://www.economist.com/news/21566442-dinner-party-problem-who-wants-be-investment-banker (describing public hostility toward investment bankers).

5 FINRA makes publicly available the professional records of each of its registrants. The records are available through the securities industry online registration and licensing database, the Central Registration Depository, also known as FINRA BrokerCheck. *FINRA*

These records list disciplinary actions brought by the Financial Industry Regulatory Authority ("FINRA"), the self-regulatory body for broker-dealers.[6] Although investment bankers do not engage in many of the activities traditionally associated with broker-dealers, such as accepting customer orders to trade securities or handling customer funds,[7] they nevertheless fall within the definition of a broker-dealer—because of their securities activities and compensation structure[8]—and must therefore individually register with FINRA and comply with its rules.[9] Investment bankers may well face criticism from Delaware courts when they are caught up in disputes involving decisions by corporate directors and officers,[10] but it is FINRA that has direct disciplinary authority over their conduct.

In many respects, FINRA is the functional equivalent of the self-regulatory bodies that govern other professionals, such as lawyers and accountants, who act on corporate and securities transactions. FINRA was formed in 2007 to supersede the National Association of Securities Dealers ("NASD"),[11] the body founded in 1939 to effectuate the principle that self-regulation is more effective than direct government regulation in policing the "ethics and morality" of broker-dealers.[12] FINRA is registered with the Securities and Exchange Commission ("SEC") as a self-regulatory organization and thus operates under SEC supervision.[13] FINRA is funded by broker-dealers,

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BrokerCheck—Research Brokers, Brokerage Firms, Investment Adviser Representatives and Investment Adviser Firms, FINRA, http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/ (last visited Jan. 11, 2015) [hereinafter *FINRA BrokerCheck*].

6 The term "broker-dealer" encompasses persons who act as brokers, dealers, or both brokers and dealers. The composite expression broker-dealer is typically regarded as a single category of securities professional. *See infra* notes 77–78 and accompanying text.

7 *See* FIN. INDUS. REGULATORY AUTH., REGULATORY NOTICE 14-09: LIMITED CORPORATE FINANCING BROKERS 2 (2014), *available at* https://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p449586.pdf (asserting in a related context that some broker-dealers "do not engage in many of the types of activities typically associated with traditional broker-dealers").

8 *See infra* Part I.B.2.

9 *See infra* Part I.B.2 (discussing the designation of investment bankers as broker-dealers and their required registration with FINRA).

10 *See infra* notes 174–91 and accompanying text (discussing cases in which the courts criticized the conduct of investment banking firms).

11 More specifically, FINRA succeeded both the National Association of Securities Dealers ("NASD") and NYSE Regulation Inc., which performed the regulatory functions of the New York Stock Exchange. *See infra* note 53 and accompanying text.

12 *See infra* notes 54–59 and accompanying text (describing the rationale given for the self-regulation of broker-dealers).

13 *See* FIN. INDUS. REGULATORY AUTH., FINRA 2012 YEAR IN REVIEW AND ANNUAL FINANCIAL REPORT 8 (2012) [hereinafter FINRA 2012 REPORT].

who are obligated to join the body as either members or associated persons.[14] It promulgates rules governing standards of conduct, the most important of which is the requirement for its members and their associated persons to "observe high standards of commercial honor and just and equitable principles of trade."[15] It has power to discipline members and associated persons for rule violations, even to the extent of barring them from practice.[16]

This Article evaluates the effectiveness of this self-regulatory system in deterring investment bankers' misconduct. Investment bankers stand astride domestic and global capital markets in advising senior managers of business firms on corporate and securities transactions, including mergers and acquisitions ("M&A"), securities offerings, and corporate restructurings.[17] Their misconduct occurs when they fail to serve client interests, protect client confidences, exercise skill and diligence, or communicate accurately and completely—all matters that are typically within the ambit of rules of professional responsibility or ethics.

The self-regulation of investment bankers has thus far attracted scant scholarly attention. Remarkably, scholars have yet to address investment bankers' designation as broker-dealers, and it is not uncommon to find discussion of the regulation of investment bankers that overlooks FINRA's role.[18] Important strands of scholarship con-

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14 *See* U.S. SEC. & EXCH. COMM'N, GUIDE TO BROKER-DEALER REGISTRATION pt. II.A (2008), *available at* http://www.sec.gov/divisions/marketreg/bdguide.htm; *see also infra* notes 79–80 (describing associated persons).

15 FINRA MANUAL R. 2010 (2008). On December 15, 2008, following a consolidation of rules, FINRA Rule 2010 replaced NASD Rule 2110. The rules are stated in identical terms. *Compare id.*, *with* NASD MANUAL R. 2110. Rule 2110 applies to all conduct on or before December 14, 2008, while Rule 2010 applies to conduct occurring thereafter. *See, e.g.*, Letter of Acceptance, Waiver and Consent No. 2008015717401 from Merrill Lynch, Pierce, Fenner & Smith Inc. to Dep't of Enforcement, Fin. Indus. Regulatory Auth. (Nov. 8, 2011). Although expressed as a member obligation, FINRA Rule 2010 also applies to associated persons. *See, e.g.*, Letter of Acceptance, Waiver & Consent No. 2011029601801 from Peter C. Bishop to Dep't of Enforcement, Fin. Indus. Regulatory Auth. (Nov. 7, 2012).

16 *See infra* notes 111–22 and accompanying text (discussing FINRA's regulation of investment bankers); *infra* note 196 and accompanying text (describing the sanctions FINRA may impose).

17 *See infra* Part I.B (describing the functions of investment bankers).

18 *See, e.g.*, Ted J. Fiflis, *Responsibility of Investment Bankers to Shareholders*, 70 WASH. U. L.Q. 497, 515 (1992) ("[Investment] [b]ankers have neither an ethics code nor a professional association to administer sanctions for deviations from norms. There is no minimum education or licensing procedure in place."); Peter J. Henning, *How Wall Street Deals with Conflicts*, N.Y. TIMES DEALBOOK (Mar. 19, 2012, 11:06 AM), http://dealbook.nytimes.com/2012/03/19/how-wall-street-deals-with-conflicts (discussing the professional responsibility rules of lawyers and observing that "no similar options [are] available to police conflicts [of interest] involving invest-

sider the self-regulation of lawyers and accountants,[19] among other professionals, but none examines that of investment bankers.[20] Scholars have studied the responsibilities of broker-dealers,[21] but they have focused on their roles as financial advisors, traders, and financial analysts,[22] not on their role as investment bankers. Some scholarship cites

ment bankers," and that "[u]ltimately, the rule of caveat emptor—let the buyer beware—is how conflicts of interest are dealt with on Wall Street").

19 *See generally* William W. Bratton, *Shareholder Value and Auditor Independence*, 53 DUKE L.J. 439 (2003); Roger C. Cramton, George M. Cohen & Susan P. Koniak, *Legal and Ethical Duties of Lawyers After Sarbanes-Oxley*, 49 VILL. L. REV. 725 (2004); Robert W. Gordon, *A New Role for Lawyers?: The Corporate Counselor After Enron*, 35 CONN. L. REV. 1185 (2003); Roberta S. Karmel, *A Delicate Assignment: The Regulation of Accountants by the SEC*, 56 N.Y.U. L. REV. 959 (1981); Susan P. Koniak, *The Law Between the Bar and the State*, 70 N.C. L. REV. 1389 (1992); Simon M. Lorne, *The Corporate and Securities Adviser, the Public Interest, and Professional Ethics*, 76 MICH. L. REV. 423 (1978); Jonathan Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167 (2003); Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and Its Public/Private Status*, 80 NOTRE DAME L. REV. 975 (2005); David B. Wilkins, *Who Should Regulate Lawyers?*, 105 HARV. L. REV. 799 (1992).

20 Scholars have, however, advocated for changes in the (legal, rather than self) regulation of investment bankers. *See* Claire Hill & Richard Painter, *Berle's Vision Beyond Shareholder Interests: Why Investment Bankers Should Have (Some) Personal Liability*, 33 SEATTLE U. L. REV. 1173, 1186–99 (2010) (arguing for limited personal liability for investment bankers and discussing options for restructuring bankers' pay); *see also* Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 278–87 (2010) (recommending the regulation of banks' executive pay as an element of financial regulation). An expansive scholarship also considers the regulation of investment banking firms as gatekeepers. *See* John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 309 (2004); Assaf Hamdani, *Gatekeeper Liability*, 77 S. CAL. L. REV. 53, 58 (2003); Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 62 (1986); Andrew F. Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583, 1588 (2010).

21 *See, e.g.*, 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, 60 (2010); Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035, 1057 (2003); Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 BUS. LAW. 395, 400–12 (2010); Donald C. Langevoort, *Brokers as Fiduciaries*, 71 U. PITT. L. REV. 439, 439 (2010); Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CALIF. L. REV. 627, 649 (1996); Norman S. Poser, *Liability of Broker-Dealers for Unsuitable Recommendations to Institutional Investors*, 2001 BYU L. REV. 1493, 1555.

22 The labels "traders" and "financial advisors" are often given to securities professionals who are regulated as broker-dealers, but who do not perform investment banking functions. Traders execute securities transactions for the accounts of either their firms or their clients. Financial advisors, often also called stockbrokers, provide some advice to their (typically retail) clients in addition to executing their trades. For a recent example of the usages of these terms, see Nelson D. Schwartz, *Going Against Type*, N.Y. TIMES, June 29, 2014, at BU1, (discussing the roles of investment bankers, traders, and financial advisors). Labels used in the securities industry have changed over time, as have the services provided. *See* Laby, *supra* note 21, at 400–12 (discussing the changes in the functions performed by broker-dealers). For analysis of the vari-

FINRA regulation as an exemplar of self-regulation, without specifically considering the effectiveness of FINRA's regulation of investment bankers.[23]

Despite this conspicuous lack of scholarly attention, investment bankers' misconduct and the effectiveness of regulatory constraints on it are issues of abiding concern. Investment bankers have ample opportunities for misconduct resulting from the nonpublic information frequently in their possession and the pervasiveness and intractability of the conflicts of interest afflicting the firms for which they work. They also face powerful incentives for misconduct given their status as perhaps the highest paid of any professional advisor and their roles advising on transactions that individually can reap tens of millions of dollars in fees.[24] Their misconduct may cause significant harm because of the magnitude and the volume of deals on which they work.[25] It may even harm the lives of common workers and ordinary investors because the transactions on which they advise may transform economies and reshape industries. The regulation of bankers' misconduct is given greater significance by revelations of questionable banker behavior in the lead-up to the financial crisis of 2008.[26]

Based on a hand-collected data set of every disciplinary matter by FINRA during the period from January 2008 (shortly after FINRA's formal organization) to June 2013, this Article shows that FINRA

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ous descriptive labels and legal designations given to securities professionals, see Barbara Black, *Brokers and Advisers—What's in a Name?*, 11 FORDHAM J. CORP. & FIN. L. 31, 35–43 (2005).

23 *See infra* note 367 and accompanying text. Recent scholarship has examined FINRA's enforcement activities (without focusing on investment bankers). *See* Barbara Black, *Punishing Bad Brokers: Self-Regulation and FINRA Sanctions*, 8 BROOK. J. CORP. FIN. & COM. L. 23 (2013) (examining the nature and extent of FINRA's enforcement activities); Jennifer J. Johnson, *Private Placements: Will FINRA Sink in the Sea Change?*, 82 U. CIN. L. REV. 465 (2013) (examining FINRA's enforcement activities against broker-dealers participating in private placements).

24 *See* KAREN HO, LIQUIDATED: AN ETHNOGRAPHY OF WALL STREET 27 (2009); MICHAEL C. JENSEN, THE FINANCIERS: THE WORLD OF THE GREAT WALL STREET INVESTMENT BANKING HOUSES 1–2 (1976) (referring to investment bankers as "the richest wage earners in the world"). As to the fees some transactions generate, see Michael J. de la Merced, *Big Fees for Advisers if Charter Wins Over Time Warner Cable*, N.Y. TIMES DEALBOOK (Jan. 14, 2014, 12:49 PM), http://dealbook.nytimes.com/2014/01/14/big-fees-for-advisers-if-charter-wins-over-time-warner-cable/ (estimating investment banking fees in one deal as between $180 and $220 million); Anita Raghavan, *Big Deals, Not Such Rich Fees for Bankers*, N.Y. TIMES DEALBOOK (Aug. 20, 2014, 10:56 AM), http://dealbook.nytimes.com/2014/08/20/big-deals-not-such-rich-fees-for-bankers/ (providing an example of deals in which investment banking fees were in the tens and hundreds of millions of dollars, but explaining that the largest deals do not always generate the highest fees).

25 *See infra* Part I.B.4.

26 *See infra* note 160 and accompanying text.

sanctions remarkably few investment bankers. During the 66-month period under investigation, FINRA sanctioned 4,116 individuals and 1,645 firms. Of these 4,116 individuals, 18 were investment bankers, and 10 of them were sanctioned for misconduct toward their clients (rather than toward other actors, such as their firms). No investment banker was sanctioned for conduct in advising on a public merger or acquisition deal or a registered securities offering—the most important transactions on which investment bankers advise. Of the 1,645 firms sanctioned, 7 faced sanctions for the misconduct of their investment bankers.

Relying on this data, the Article argues that the current system of self-regulation underdeters investment bankers' misconduct and fails to credibly deter such misconduct at all. In addition, the burdens of the existing approach to self-regulation may well exceed its benefits.[27] Other techniques for regulating bankers' conduct, including private and SEC enforcement, are unlikely to compensate for the weak deterrence force of self-regulation.[28] Yet self-regulation generally offers distinct advantages over these other techniques, including the ability to impose more fine-grained rules.[29] Therefore, although the current approach to self-regulation is failing, this Article argues that self-regulation must be retained and improved.

The Article assesses deterrence using the analytical tools of optimal deterrence theory,[30] thus focusing on the probability and magnitude of sanctions imposed by FINRA. To assess the probability of sanctions, the Article considers FINRA's enforcement activity in relation to empirical and other evidence of investment bankers' misconduct,[31] concluding that the probability of sanction is low, and possibly even infinitesimally low.[32] Moreover, investment bankers are unlikely to have perceived the probability of being sanctioned as higher than the reality. To assess the magnitude of sanctions, the Article considers the severity of sanctions imposed.[33] These sanctions are relatively modest, or at least generally commensurate with the harms created, and thus insufficient to offset the low probability of being sanctioned.[34] Due to the very low probability of being sanctioned, more

27 *See infra* Part III.A.

28 *See infra* Part III.C.

29 *See infra* notes 53–59 and accompanying text.

30 *See infra* note 225.

31 *See infra* Part I.B.4.

32 *See infra* Part III.A.2.

33 *See infra* Part III.A.2.

34 *See infra* Part III.A.2.

significant sanctions would be necessary to achieve optimal deterrence. Additionally, nothing suggests that the cost of further deterring investment bankers' wrongdoing would be greater than the benefit of doing so.[35] Therefore, FINRA regulation underdeters investment bankers' misconduct. It would also seem to provide no credible deterrence against such misconduct. Considering FINRA's apparently weak deterrence and the costs of administering this regime, the Article argues that the self-regulation of investment bankers, as currently administered, likely creates more trouble than it is worth.

The Article attributes FINRA's weak deterrence of investment bankers' misconduct to a range of factors. These include FINRA's lack of institutional expertise and the generality of its rules, its investigative approach and narrow subpoena power to compel the production of documents and testimony, the exalted status that investment bankers enjoy, and FINRA's stated regulatory priorities.[36] A combination of these factors is likely to explain—but not justify—FINRA's weak enforcement activity.

The Article also examines other mechanisms for deterring investment bankers' misconduct, including reputational constraints and private and SEC enforcement.[37] Although the Article does not undertake a detailed assessment of SEC enforcement, it preliminarily concludes that these other mechanisms fail to compensate for FINRA's weak deterrence, leaving investment bankers underdeterred.

The evidence therefore reveals that FINRA is not satisfying its statutory obligation to enforce its rules against all broker-dealers, including investment bankers. The Article recommends reforms to bolster deterrence without requiring significant additional resources. These reforms include targeting instances of investment banker misconduct identified by experts such as Delaware courts, as well as promulgating cannons of professional responsibility for investment bankers along the lines of those for lawyers and accountants. The Article also suggests resource-intensive reforms, including the formation of a dedicated self-regulatory body with expertise in investment banking, either internal or external to FINRA. Such an investment banking regulator could undertake independent investigative field work to

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35 *See infra* Part III.A.2.

36 *See infra* Part III.B.

37 *See infra* Part III.C.

detect bankers' misconduct—rather than pursuing only client complaints—with broad subpoena power to aid its enforcement efforts.

The Article proceeds as follows. Part I discusses the self-regulatory regime for broker-dealers and its application to investment bankers. Part II presents evidence of FINRA's enforcement activity against investment bankers and their firms. Part III evaluates the effectiveness of FINRA's enforcement in deterring investment bankers' misconduct, as well as the effectiveness of other disciplinary mechanisms. It also assesses the most plausible explanations for the results. The implications of that analysis are considered in Part IV. A brief conclusion follows.

I. Self-Regulation and Investment Bankers

This Part discusses the various building blocks for the analysis, including the system of self-regulation for broker-dealers and its application to investment bankers.

A. *Self-Regulation*

Self-regulation forms a part of the regulatory framework for certain acknowledged professions.[38] Generally speaking, self-regulation means that bodies comprising members of a profession both prescribe rules governing conduct and adjudicate complaints involving those rules.[39] For instance, the American Bar Association formulates rules

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38 Although not all professions have self-regulatory regimes, the legal, accounting, and medical professions arguably do. *See* Sande L. Buhai, *Profession: A Definition*, 40 FORDHAM URB. L.J. 241, 271–74 (2012). That claim depends on the terms "profession" and "self-regulation." The term "profession" has various meanings in sociological literature. *See* Richard A. Posner, *Professionalisms*, 40 ARIZ. L. REV. 1, 1–2 (1998). In this Article, it denotes occupations involving the provision of services by licensed individuals to clients, the imposition of obligations of conduct on those licensed individuals, and justifiable client expectations of loyal or independent service by those licensed individuals.

The term "self-regulation" lacks definitional clarity. For a discussion, see Saule T. Omarova, *Wall Street as Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411, 422–27 (2011). Self-regulation encompasses a range of institutional arrangements between purely private ordering on the one hand and heavy state intervention on the other. *See* Anthony Ogus, *Self-Regulation*, *in* 5 ENCYCLOPEDIA OF LAW AND ECONOMICS 587, 588–89 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000). Importantly, the term is not used here to suggest the absence of government regulation or other external constraints.

39 *See* Buhai, *supra* note 38, at 271 ("[Self-regulation means that] complaints about professional misconduct are referred to agencies mostly comprised of members of the profession."). These bodies may be subject to government intrusion and even directly supervised by the government. For a recent analysis of the trend toward the "governmentalization" of self-regulators, see William A. Birdthistle & M. Todd Henderson, *Becoming a Fifth Branch*, 99 CORNELL L. REV. 1 (2013).

of professional conduct for lawyers.[40] These rules, which provide a blueprint for state legal ethics codes,[41] are applied by state courts and state bar associations to adjudicate complaints against lawyers.[42] For accountants, the American Institute of Certified Practicing Accountants adopts a code of professional regulation for its members.[43] Disputes concerning its members are adjudicated by the institute's Professional Ethics Division or related state associations.[44]

Rules promulgated by self-regulators govern various matters and are generally described as professional responsibilities or professional ethics.[45] Though the rules range broadly, they typically require professionals to act with skill and diligence, to communicate truthfully, to protect client confidences, and to act beyond their self interests in certain contexts.[46]

Where self-regulation exists, it typically serves as one deterrence mechanism among many within a broader regulatory framework. Lawyers, for instance, also face administrative regulation and civil lawsuits invoking common law or statutory causes of action.[47] Accountants face regulation by the Public Company Accounting Oversight Board, the body created by the Sarbanes-Oxley Act of 2002[48] and overseen by the SEC, as well as civil lawsuits.[49] Although its in-

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40 *See* MODEL RULES OF PROF'L CONDUCT (1983).

41 RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 1 cmt. b (2000).

42 Buhai, *supra* note 38, at 272 ("The states regulate lawyers mostly through their individual high courts or State Bar Associations.").

43 *See* AICPA CODE OF PROFESSIONAL CONDUCT AND BYLAWS § 51.02 (2013). Since the creation of the Public Company Accounting Oversight Board ("PCAOB") in 2002, auditors of public companies have been required to register with that body. *See* PCAOB R. 2100 (2014), *available at* pcaobus.org/Rules/PCAOBRules/Documents/Section_2.pdf. The PCAOB is not a self-regulator.

44 *See Ethics Enforcement*, AICPA, http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/EthicsEnforcement/Pages/default.aspx (last visited Jan. 11, 2015).

45 *See, e.g.*, RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 1 cmt. b (2000).

46 *See* MODEL RULES OF PROF'L CONDUCT R. 1.1–1.18, 8.1–8.5 (1983); AICPA CODE OF PROFESSIONAL CONDUCT AND BYLAWS §§ 51–57, 101, 102, 301 (2013).

47 For discussion of the various non-self-regulatory constraints on lawyers, see, for example, Ted Schneyer, *From Self-Regulation to Bar Corporatism: What the S&L Crisis Means for the Regulation of Lawyers*, 35 S. TEX. L. REV. 639 (1994); Wilkins, *supra* note 19; Fred C. Zacharias, *The Myth of Self-Regulation*, 93 MINN. L. REV. 1147 (2009).

48 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

49 For discussion of the various non-self-regulatory constraints on accountants, see Jerry Wegman, *Impact of the Sarbanes-Oxley Act on Accountant Liability*, 10 J. LEGAL ETHICAL & REG. ISSUES 1 (2007). While established as a private "nonprofit corporation" and modeled on self-regulatory organizations in the securities industry, the PCAOB is "part of the Government" for constitutional purposes. *See* Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 561 U.S. 477, 484–86 (2010) (internal quotation marks omitted). It is thus neither a government agency nor a self-regulator, but something of a hybrid. Unlike FINRA, the PCAOB was directly

tensity varies across contexts, self-regulation serves a crucial role in regulating professionals generally.

FINRA is the financial industry equivalent of the self-regulators in other acknowledged professions. Congress authorized self-regulatory organizations in the securities industry in the late 1930s by amending the Securities Exchange Act of 1934[50] (the "Exchange Act") to allow the formation of self-regulatory bodies for broker-dealers to supplement SEC oversight.[51] Only one such body was authorized: the NASD, an association comprised of—and funded by—broker-dealers that operated under SEC oversight.[52] The NASD survived until 2007, when it merged with the enforcement arm of the New York Stock Exchange to form FINRA.[53]

The self-regulation of broker-dealers finds justification in the advantages it offers over direct government regulation.[54] As an early Chair of the SEC explained, self-regulation has the ability to regulate conduct and activity "too minute for satisfactory control; some of it lying beyond the periphery of the law in the realm of ethics and morality."[55] He further explained that "[i]nto these large areas self-government, and self-government alone, can effectively reach."[56] Self-regulatory efforts to shape conduct may be better received by the

established by Congress, enjoys power to compel the production of documents and testimony from third parties, and is not funded by its members. *See* Nagy, *supra* note 19, at 1022–26.

50 Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78pp (2012)).

51 *See id.* For a concise discussion of the adoption of self-regulation in the securities industry and its emergence independent of state intervention, see JOHN C. COFFEE, JR. & HILLARY A. SALE, SECURITIES REGULATION: CASES AND MATERIALS 628–31 (12th ed. 2012).

52 Section 15A of the Exchange Act permits an association of brokers and dealers to register as a national securities association. *See* Securities Exchange Act § 15A, 15 U.S.C. § 78o-3.

53 Established on July 30, 2007, FINRA consolidated the functions of the NASD and the NYSE Regulation Inc. *See* News Release, Fin. Indus. Regulatory Auth., NASD and NYSE Member Regulation Combine to Form the Financial Industry Regulatory Authority—FINRA, July 30, 2007, *available at* http://www.finra.org/Newsroom/NewsReleases/2007/p036329. Prior to its transformation into the NASD, it was known as the Investment Bankers Conference. *See* VINCENT P. CAROSSO, INVESTMENT BANKING IN AMERICA: A HISTORY 392 (1970). I thank Donna Nagy for directing me to this reference.

For a concise discussion of the formation and early days of the NASD, see JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 185–89 (3d ed. 2003); Birdthistle & Henderson, *supra* note 39, at 17–22.

54 *See generally* COFFEE & SALE, *supra* note 51, at 629 (discussing the enforcement advantages of securities self-regulatory organizations).

55 *See* SELIGMAN, *supra* note 53, at 185–86 (quoting William O. Douglas, then Chairman of the SEC, discussing the "unquestioned advantages" of self-regulation over direct SEC enforcement).

56 *Id.* (internal quotation marks omitted).

market professionals, and thus more effective, than impositions from outside.[57] Self-regulatory initiatives are also likely to be better tailored to specific industry needs than other mechanisms, given self-regulators' close industry ties.[58] Self-regulators may enjoy cost advantages in formulating and interpreting rules, since they typically have greater degrees of expertise and technical knowledge than government regulators.[59] They may thus shape conduct beyond the reach of law and regulation.

B. *Investment Bankers*

1. *Functions and Organizational Context*

Investment bankers steer the transactions that help shape corporate America.[60] Primarily, investment bankers link investors and investors' capital with businesses in search of such resources.[61] More specifically, investment bankers advise senior managers of business firms on corporate and securities transactions, including M&A, securities offerings, and corporate restructurings.[62] They also advise on the value of financial instruments, the operation of financial markets,

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57 *See* ANNELISE RILES, COLLATERAL KNOWLEDGE: LEGAL REASONING IN THE GLOBAL FINANCIAL MARKETS 227 (2011) (discussing the "empirical reality" of market participants seeking to circumvent new financial regulatory measures and the factors affecting an actor's compliance with regulation).

58 *See* Birdthistle & Henderson, *supra* note 39, at 55 ("Perhaps the greatest single benefit that self-regulation possesses over other forms of regulation is its access to direct industry expertise.").

59 *See* Ogus, *supra* note 38, at 591.

60 The term "investment banker" is not a term of art in law. However, it does have a widely accepted meaning in legal, business, economic, and other scholarship, as well as in industry parlance. In defining the investment banker, this Part draws both on that scholarship and on interviews with industry professionals. *See infra* notes 62–68. Importantly, the definition employed here is consistent with the description of investment bankers' functions recently provided by FINRA. *See infra* notes 100–03 and accompanying text.

61 *See* CHARLES R. GEISST, INVESTMENT BANKING IN THE FINANCIAL SYSTEM 1–2 (1995).

62 *See, e.g.*, ALAN D. MORRISON & WILLIAM J. WILHELM, JR., INVESTMENT BANKING: INSTITUTIONS, POLITICS, AND LAW 22 (2007) ("Traditional investment banking relates to advisory work in securities issuance, and also in the M&A market."); *see also* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 115 (7th ed. 2013) ("[I]nvestment banking includes the underwriting of securities offerings; it also refers to the wide range of financial planning and assistance services that investment banking firms render in connection with mergers, acquisitions, and recapitalizations."); *id.* at 175–82, 251–55 (describing investment banking firms' role in managing corporate reorganizations); BRUCE WASSERSTEIN, BIG DEAL: 2000 AND BEYOND 556 (2000) ("As far back as J.P. Morgan's U.S. Steel deal of 1901, bankers have been involved in an advisory capacity in major corporate transactions.").

The term "mergers and acquisitions" is used broadly to include numerous types of often overlapping transaction categories, however structured, including purchases and sales of businesses or assets, going-private transactions, and divestitures.

market and industry trends, the structuring of transactions, investment strategies and risks, and other matters requiring financial training and acumen.[63]

In the context of securities offerings, investment bankers perform a distinctive role. The process of offering securities divides naturally into two parts.[64] In the first "client-facing" part, the investment banking firm counsels the corporate issuer and, if it underwrites the offering on a firm-commitment basis, commits to acquiring the issuer's

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63 *See generally* FIN. INDUS. REGULATORY AUTH., INVESTMENT BANKING REPRESENTATIVE QUALIFICATION EXAM (TEST SERIES 79): CONTENT OUTLINE 6–22 (2014) [hereinafter FINRA INVESTMENT BANKING QUALIFICATION EXAM], *available at* http://www.finra.org/web/groups/industry/@ip/@comp/@regis/documents/industry/p119446.pdf (describing investment banker functions).

More specifically, in providing M&A advice, an investment banker will advise on the merits of the proposed transaction, including its timing, structuring, and pricing; provide valuation analyses and fairness opinions; evaluate and recommend alternative transactions; analyze and advise on potential financing for the transaction; assist in preparing an offering document or other disclosure materials; and help to negotiate and consummate the proposed transaction. *See generally* Andrew F. Tuch, *Investment Banks as Fiduciaries: Implications for Conflicts of Interest*, 29 MELB. U. L. REV. 478 (2005) [hereinafter Tuch, *Investment Banks as Fiduciaries*]. *See also* WASSERSTEIN, *supra* note 62, at 561–62 (discussing the services investment bankers provide on M&A deals).

In a securities offering, the investment banker will advise management on matters including the merits and form of the offering, the design and marketing of securities, and alternative forms of fundraising. In a firm-commitment underwriting, the investment banker's firm will assume the risk that the securities will not be purchased in full by investors and also distribute the securities to investors, but the investment banker individually will perform an advisory role to the corporate issuer. Professors Gilson and Kraakman regard securities underwriters as performing three principal functions: verifying the issuer's disclosures ("which is particularly important in the context of new issues and other innovations"); distributing (or marketing) securities; and assuming risk. Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 616–19 (1984). However, the advisory role is particularly salient. For a discussion of the functions performed by securities underwriters, see Andrew F. Tuch, *Securities Underwriters in Public Capital Markets: The Existence, Parameters and Consequences of the Fiduciary Obligation to Avoid Conflicts*, 7 J. CORP. L. STUD. 51, 54–61 (2007) [hereinafter Tuch, *Securities Underwriters*]. *See also* EBC I, Inc. v. Goldman, Sachs & Co., 832 N.E.2d 26, 31–32 (N.Y. 2005) (describing the advisory role performed by securities underwriters); Nicholas Wolfson, *Investment Banking*, *in* ABUSE ON WALL STREET: CONFLICTS OF INTEREST IN THE SECURITIES MARKETS—REPORT TO THE TWENTIETH CENTURY FUND STEERING COMMITTEE ON CONFLICTS OF INTEREST IN THE SECURITIES MARKETS 365, 419 n.1 (1980) (stating that one function of underwriters is to "act as financial counsel to the issuer").

64 Citing Vincent Carosso, Professor Hayes and his co-authors categorize securities underwriting into four distinct parts or functions; the first three of those (origination, purchase, and banking) are described compendiously by the first part in the text above. HAYES ET AL., *supra* note 4, at 14. Their fourth part corresponds with the second part described in the text above. *Id.* ("In practice, however, the first three functions were the responsibility of the originating house (or houses), usually an apex firm. This manager (or comanager) function stood clearly separate from the distribution function."). *But see* GEISST, *supra* note 61, at 1 (suggesting that retail brokerage is an investment banking activity).

securities; in the second "investor-facing" part, those securities are sold to investors.[65] While many investment banking firms perform both parts of the process,[66] different securities professionals are responsible for each part. Investment bankers perform the first part, counseling senior managers of the issuer, while traders or financial advisors perform the second part, selling those securities to investors.[67] Accordingly, investment bankers do not typically sell securities, even though underwriting requires the sale of securities to investors.[68]

Although the organizational structure and legal designation of major investment banking firms have changed dramatically in recent decades, the services that investment bankers perform have remained stable. The 1930s saw investment banks separate from commercial banks in response to the Glass-Steagall Act.[69] The 1970s and 1980s saw the rise of M&A and the diversification of investment banks into other activities, including asset management and proprietary trading.[70]

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65 *See* Wolfson, *supra* note 63, at 418–19 n.1. The terms "client-facing" and "investor-facing" used in this Article are adopted from NIAMH MOLONEY, HOW TO PROTECT INVESTORS: LESSONS FROM THE EC AND THE UK (2010).

66 But not all investment banking firms performed both parts of the process. Wolfson, *supra* note 63, at 418–19 n.1 ("In the past many underwriters relied on retail firms for distribution, but during the past ten years, the trend has been for underwriters to sell directly to investors."); *see also* PHILIP AUGAR, THE GREED MERCHANTS: HOW THE INVESTMENT BANKS PLAYED THE FREE MARKET GAME 16 (2005) (discussing the involvement of an investment bank's trading arm in assisting a firm's investment banking arm to underwrite securities); HAYES ET AL., *supra* note 4, at 46–47 (describing the differing degrees to which investment banking firms engaged in selling securities).

67 *See* GEISST, *supra* note 61, at 2 ("[I]nvestment bankers put much of their time and effort into helping companies design deals and the securities to finance them. Once finished, they used brokers [that is, traders or financial advisors] to actually sell the securities to the investing public . . . ."). Despite the division of functions, investment bankers may be involved in roadshow presentations to potential investors; they may also be involved in "bookbuilding," the process of determining potential investor demand for the offering.

68 FINRA shares the view of investment bankers described here. In setting out eligibility criteria for Series 79 qualifications, FINRA defines investment bankers as not interacting with investors or potential investors, and instead as interacting with their clients—that is, with business firms seeking their financial counsel. Accordingly, the Series 79 qualification does not qualify an associated person to "actively market [a securities] offering and interact with investors or potential investors." *See Qualifications Frequently Asked Questions (FAQ)—Investment Banking*, FINRA, http://www.finra.org/Industry/Compliance/Registration/QualificationsExams/Qualifications/faq/P124190 (last visited Jan. 11, 2015).

69 Glass-Steagall Act, Pub. L. No. 73-66, 48 Stat. 162 (1933). The Glass-Steagall Act banned firms from both underwriting securities and lending to or borrowing from the public. *See id.*

70 During this period, investments banks began branching into other financial activities, including securities trading for institutional investors, proprietary trading, managing assets for outside investors, and merchant banking. For extensive treatments of these developments, see

That period also saw investment banks facing increased competition from commercial banks as the Glass-Steagall Act's restrictions eroded before being largely removed in 1999.[71] The financial crisis of 2008 led major investment banks to fail, sell themselves to bank holding companies, or convert to bank holding companies.[72] Despite these changes, the services performed by investment bankers remain those described above: advising senior managers on M&A, securities offerings, and other corporate and securities transactions.[73] The firms themselves—described in this Article as investment banking firms—are structured as conglomerates and provide a broad and diverse range of financial services.[74]

2. *Designation as Broker-Dealers*

With the exception of natural persons employed by a broker-dealer,[75] the Exchange Act generally requires broker-dealers to regis-

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JOSEPH AUERBACH & SAMUEL L. HAYES, III, INVESTMENT BANKING AND DILIGENCE: WHAT PRICE DEREGULATION? 89–94 (1986); MORRISON & WILHELM, *supra* note 62, at 225–49.

71 SAMUEL L. HAYES III & PHILIP M. HUBBARD, INVESTMENT BANKING: A TALE OF THREE CITIES 112 (1989) ("[B]y the end of the 1980s, successive assaults on the status quo had substantially altered the impact of the 1930s reform legislation. The Glass-Steagall wall separating commercial and investment banking had been substantially eroded . . . ."); *see also* FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 54–55 (2011) (discussing the erosion of the Glass-Steagall Act).

72 *See* FIN. CRISIS INQUIRY COMM'N, *supra* note 71, at 362–63.

73 *See supra* note 63 and accompanying text; *see also* Gina Chon & Simone Foxman, *Morgan Stanley Is Having an Identity Crisis*, QUARTZ (July 17, 2013), http://qz.com/83670/morgan-stanley/ ("Properly speaking, 'investment banking' refers only to advisory services (helping companies with M&A) and underwriting (arranging for them to issue shares.)").

In one respect the role of investment bankers has blurred with that of traders. Some individuals at financial conglomerates both originate and underwrite financial instruments, such as mortgage-backed securities. Such positions combine trading and investment banking functions. *See, e.g.*, The Goldman Sachs Grp., Inc., Annual Report (Form 10-K) (Feb. 28, 2013) [hereinafter Goldman Sachs Annual Report], *available at* http://www.sec.gov/Archives/edgar/data/886982/000119312513085474/d446679d10k.htm (referring to the originating and underwriting of financial instruments, including asset-backed securities, as part of the firm's investment banking activities).

74 The term investment bank is avoided because investment banking services are increasingly provided by firms that historically provided commercial banking services and because most major investment banking firms today are structured as bank holding companies (the legal structure historically associated with commercial banking). *See* Michael J. de la Merced et al., *As Goldman and Morgan Shift, a Wall St. Era Ends*, N.Y. TIMES DEALBOOK (Sept. 21, 2008, 9:35 PM), http://dealbook.nytimes.com/2008/09/21/goldman-morgan-to-become-bank-holding-companies/?_php=true&_type=blogs&_r=0. Elsewhere I describe these firms as financial conglomerates. *See* Andrew F. Tuch, *Financial Conglomerates and Information Barriers*, 39 J. CORP. L. 563, 564 (2014).

75 The Exchange Act exempts natural persons from registering with the SEC if they are

ter with the SEC.[76] Under the Exchange Act, a "'broker' means any person engaged in the business of effecting transactions in securities for the account of others,"[77] while a "dealer" is one who engages in "the business of buying and selling securities . . . for such person's own account."[78] The commonly used expression "broker-dealer" encompasses persons who act as brokers, dealers, or both brokers and dealers.

Broker-dealers must also register with FINRA as either members or associated persons.[79] Generally speaking, SEC-registered broker-dealers must register with FINRA as members, while other broker-dealers (those employed by a broker-dealer firm) must register as associated persons. FINRA's rules apply to members and associated persons alike.[80]

Scholars have yet to address whether investment bankers are broker-dealers, and some have even assumed (without examination) that

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"associated with" firms that are registered as broker-dealers. *See* 15 U.S.C. § 78o(a)(1) (2012) (relieving a broker or dealer "associated with a broker or dealer which is a person other than a natural person" from registration). Because investment bankers typically are employed by firms registered as broker-dealers, they are "associated persons" and usually exempt from being so registered. *See id.* § 78c(a)(18) (defining the term "person associated with a broker or a dealer").

76 *See* Securities Exchange Act of 1934 § 15(a), 15 U.S.C § 78o(a)(1). More specifically, Section 15(a)(1) bans any broker-dealer from effecting any transaction in securities or from inducing or attempting to induce the purchase or sale of any security, with limited exceptions, unless that broker-dealer is registered with the SEC. *See id.*

77 Securities Exchange Act of 1934 § 3(a)(4), 15 U.S.C. § 78c(a)(4)(A) (2012).

78 15 U.S.C. § 78c(a)(5)(A). Accordingly, a person who buys or sells securities for himself or herself but not as part of a regular business is not a broker-dealer. *See* Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, 67 Fed. Reg. 67,496, 67,499 (proposed Nov. 5, 2002) (to be codified at 17 C.F.R. 240.3a5-1, 3b-18).

79 With exceptions, Section 15(b)(8) of the Exchange Act requires broker-dealers effecting transactions in securities or inducing or attempting to induce the purchase or sale of any security to become a member of a securities association registered under Section 15A of the Exchange Act. *See* Securities Exchange Act § 15(b)(8), 15 U.S.C. § 78o(b)(8); *see also* U.S. SEC. & EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS: AS REQUIRED BY SECTION 913 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT 47 & n.198 (2011) [hereinafter SEC BROKER-DEALER STUDY]. FINRA is the only such securities association. Securities Exchange Act Rule 15b9-1 exempts broker-dealers that carry no customer accounts from FINRA membership in limited circumstances. *See* 17 C.F.R. § 240.15b9-1 (2014). In effect, all "broker-dealers that deal with the public must become members of FINRA." SEC BROKER-DEALER STUDY, *supra*, at 47. Broker-dealers may also choose to become members of a national securities exchange, such as the New York Stock Exchange. *See id.* FINRA also enforces compliance with the rules of the NYSE. *See id.* at n.198.

80 *See* FINRA MANUAL R. 0140(a) (2008) (providing that "[p]ersons associated with a member shall have the same duties and obligations as a member under the [FINRA] Rules").

they are not.[81] This oversight is certainly understandable, as investment bankers do not engage in activities generally associated with traditional broker-dealers.[82]

Nevertheless, investment bankers are properly designated as broker-dealers. This conclusion is consistent with FINRA's practice of setting certain rules that apply specifically to investment bankers and sanctioning some investment bankers for violating its rules.[83] In its *Guide to Broker-Dealer Registration*, the SEC recognizes that investment bankers may qualify as broker-dealers,[84] but determining precisely when and why requires reference to SEC interpretive guidance, no-action letters, and enforcement actions. These sources set out relevant factors for determining whether a person is engaged in the business of "effecting transactions in securities for the account of others," and therefore a broker.[85]

The investment banker acting as an M&A advisor will qualify as a broker where the banker is actively involved in securities transactions (the sale or exchange of securities, as opposed to mere asset sales) and receives transaction-dependent fees.[86] To be actively involved, bankers must do more than simply introduce parties to transactions; they must participate in "important parts" of transactions, such as soliciting, structuring, negotiating, or executing them.[87] As

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81 Because investment bankers do not typically engage in the business of buying and selling securities for their own accounts, they are unlikely to be dealers. Nevertheless, their designation as brokers is sufficient for them to be regulated as broker-dealers.

82 *See supra* notes 77–78 AND ACCOMPANYING TEXT.

83 *See infra* Part I.B.3 (describing registration rules for investment bankers); *infra* Part II.B (describing FINRA disciplinary matters against investment bankers or against firms for the conduct of investment bankers).

84 *See* U.S. SEC. & EXCH. COMM'N, *supra* note 14, at pt. II.A (recognizing that "activities relating to mergers and acquisitions where securities are involved" may require registration as a broker).

85 Securities Exchange Act of 1934 § 3(a)(4), 15 U.S.C. § 78c(a)(4)(A) (2012).

86 *See* Robert L.D. Colby & Lanny A. Schwartz, *What Is a Broker Dealer?*, *in* BROKER-DEALER REGULATION 2-1, 2-22 (Clifford E. Kirsch ed., 2d ed. 2012); *see also* Herbruck, Alder & Co., SEC No-Action Letter, 2002 WL 1290291 (June 4, 2002) (referring to the receipt of "transaction-based compensation" as a key factor that may require an entity to register as a broker-dealer).

87 *See* U.S. SEC. & EXCH. COMM'N, *supra* note 14, at pt. II.A (identifying the solicitation, negotiation, and execution of transactions as important in determining whether a person is a broker); *see also* Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. 6006, 6014 n.82 (Feb. 5, 2003) (to be codified at 17 C.F.R. pts. 210, 240, 249, 274) (stating that a person may "effect transactions," for purposes of the Exchange Act definition of broker "by assisting an issuer to structure prospective securities transactions"); May-Pac Mgmt. Co., SEC No-Action Letter, 1973 WL 10806 (Dec. 20, 1973) ("[P]ersons who play [an] integral role in negotiating and effecting mergers or acquisitions that involve transactions in

core advisors in transactions, investment bankers routinely perform these functions.

Other materials provide similar guidance. In their manual for securities practitioners, Robert Colby and Lanny Schwartz assert that "persons (other than professionals such as lawyers or accountants acting as such) who participate in or otherwise facilitate negotiations in effecting mergers or acquisitions, and receive transaction-based compensation, are required to register as broker-dealers."[88] In no-action letters in 2012 and 2014, the SEC endorsed the general designation of M&A advisors as broker-dealers.[89] As a matter of practice, according to a memorandum by one prominent law firm, "FINRA has traditionally considered M&A to be a broad category of activity for its members that requires US broker-dealer registration."[90]

Investment bankers advising on securities offerings are also brokers. Like M&A advisors, they "participate in important parts of a securities transaction," including its negotiation and execution—a factor indicating that they "effect" transactions in securities.[91] Other broker activities include "assisting an issuer to structure prospective securities transactions"[92] and "negotiating between the issuer and the

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securities generally are deemed to be either a broker or a dealer, depending upon their particular activities, and are required to register with the [SEC].").

88 Colby & Schwartz, *supra* note 86, at 2-22. For a detailed discussion of the SEC no-action guidance, see HUGH H. MAKENS, CAPITAL FORMATION MAKING "FINDERS" VIABLE 8–9 (2004), *available at* http://www.sec.gov/info/smallbus/hmakens.pdf.

89 In 2012, in response to a request by a non-U.S. M&A advisor seeking exemption from broker-dealer registration, the SEC stated that the advisor would be required to register as a broker-dealer if the advisor were a domestic firm. *See* Ernst & Young Corporate Finance (Canada) Inc., SEC No-Action Letter, 2012 WL 10715930 (July 12, 2012). In a 2014 no-action letter, the SEC conditionally exempted certain advisors to private-company M&A transactions from registering as broker-dealers, further confirming the general principle that investment bankers advising on M&A transactions must register as broker-dealers. *See* Faith Colish, Martin A. Hewitt, Eden L. Rohrer, Linda Lerner, Ethan L. Silver & Stacey E. Nathanson, SEC No-Action Letter, 2014 WL 466136 (revised Feb. 4, 2014). The no-action letter was provided against the backdrop of bills in both houses of Congress to exempt certain M&A advisors to small-scale transactions from registration as broker-dealers. *See SEC Provides No-Action Relief for M&A Brokers*, MORGAN LEWIS (Feb. 5, 2014), http://www.morganlewis.com/pubs/IM_LF_SECProvidesNoActionRelieforMABrokers05feb14 (discussing legislative efforts to provide relief from broker-dealer registration to M&A advisors).

90 D. Grant Vingoe & Richard Werner Fagerer, *SEC Staff Provides Limited Relief for Non-US M&A Advisory Firms*, NORTON ROSE FULBRIGHT (Aug. 13, 2013), http://www.nortonrosefulbright.com/knowledge/publications/102365/sec-staff-provides-limited-relief-for-non-us-ma-advisory-firms.

91 U.S. SEC. & EXCH. COMM'N, *supra* note 14, at pt. II.A; *see also* Colby & Schwartz, *supra* note 86, at 2-12.

92 Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. 6006, 6014 n.82 (Feb. 5, 2003) (to be codified at 17 C.F.R. pts. 210, 240, 249, 274)

investor."[93] Participation in structuring transactions for issuers is a strong indicator of broker activity, especially when combined with transaction-based compensation.[94] Investment bankers advising on securities transactions are properly regarded as brokers, as they typically counsel issuers on structuring transactions and are compensated (through the entity employing them) by commissions calculated on the value of securities sold.

As broker-dealers, investment bankers must register as such with the SEC, unless they are employed by a broker-dealer firm, in which case they are exempt from SEC registration.[95] In either case, however, they must register with FINRA, as either a member or an associated person, and are thereby subject to its rules.[96]

Because virtually all investment bankers are employed by broker-dealers, they generally register with FINRA as associated persons. This practice is readily observable, because the registration and disciplinary history of every FINRA registrant is publicly available.[97]

3. *Regulation as Broker-Dealers*

FINRA enjoys what the SEC regards as "primary responsibility for the regulatory oversight of a broker-dealer's activity."[98] To register with FINRA, investment bankers must satisfy certain qualification requirements, including paying various fees and passing FINRA-administered exams. Investment bankers become "general securities representatives" by passing the Series 7 exam.[99] They may also become "limited representative[s]—investment banking" by passing the Series 79 exam.[100] The Series 79 qualification, introduced in 2009, is

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(stating that a person may "effect transactions," for purposes of the Exchange Act definition of broker, "by assisting an issuer to structure prospective securities transactions, by helping an issuer to identify potential purchasers of securities, or by soliciting securities transactions").

93 Colby & Schwartz, *supra* note 86, at 2-12.

94 *See id.*

95 *See supra* note 79 and accompanying text.

96 *See supra* notes 79–80 and accompanying text.

97 *See FINRA BrokerCheck*, *supra* note 5. A selective review of public records shows that the practice of investment bankers registering with FINRA is longstanding: even before FINRA's formation in 2007, investment bankers typically registered as associated persons with the NASD.

98 *See* SEC Broker-Dealer Study, *supra* note 79, at A-7.

99 *See* Fin. Indus. Regulatory Auth., General Securities Representative Qualification Examination (Series 7): Content Outline (2014), *available at* http://www.finra.org/web/groups/industry/@ip/@comp/@regis/documents/industry/p124292.pdf.

100 *See FINRA Registration and Examination Requirements*, FINRA, http://www.finra.org/industry/compliance/registration/qualificationsexams/qualifications/p011051 (last updated Oct. 15, 2014).

intended to equip candidates with the "knowledge, skills and abilities needed to perform the major functions of an entry-level investment banker."[101]

Both generally applicable FINRA rules and FINRA rules specific to investment banking govern investment bankers' conduct.[102] The generally applicable FINRA Rule 2010 requires members and associated persons "in the conduct of [their] business, [to] observe high standards of commercial honor and just and equitable principles of trade."[103] Referred to as the "just and equitable" requirement, this rule is FINRA's most commonly invoked rule.[104]

FINRA interprets the rule broadly, using it to punish conduct that is "inconsistent with ethical standards in the securities industry"[105]—standards FINRA determines through its enforcement activity. The rule is powerful—it provides a basis for disciplining registrants for "unethical behavior," whether or not that behavior vio-

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101 *See* FINRA INVESTMENT BANKING QUALIFICATION EXAM, *supra* note 63, at 2; *see also* FIN. INDUS. REGULATORY AUTH., REGULATORY NOTICE 09-41: SEC APPROVES RULE CHANGE CREATING NEW LIMITED REPRESENTATIVE—INVESTMENT BANKER REGISTRATION CATEGORY AND SERIES 79 INVESTMENT BANKING EXAM 4 (2009), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p119461.pdf.

102 The generally applicable FINRA rules for broker-dealers relate to qualifications, business conduct, market manipulation, and financial soundness. For a more detailed discussion of these rules, see COFFEE & SALE, *supra* note 51, at 632–95. Most of these rules were developed by the NASD or NYSE, the organizations FINRA superseded in 2007. Those described in this Section are of the most immediate relevance to investment bankers.

Broker-dealers engaging in transactions in municipal securities must also comply with the rules of the Municipal Securities Rulemaking Board ("MSRB"). *See* 15 U.S.C. § 78o-4(a)(1)(B) (2012) ("It shall be unlawful for a municipal advisor to provide advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, or to undertake a solicitation of a municipal entity or obligated person, unless the municipal advisor is registered . . . ."); *see also Municipal Securities Dealer Registration*, MUN. SEC. RULEMAKING BOARD, http://www.msrb.org/MSRB-For/Dealers/Dealer-Regulation.aspx (last visited Jan. 11, 2015) ("All broker-dealers and banks that underwrite, trade and sell municipal securities . . . must register with the MSRB . . . as required by Section 15(b) of the Securities Exchange Act.").

103 FINRA MANUAL R. 2010 (2008); *see also supra* note 15 (comparing FINRA Rule 2010 and its predecessor NASD Rule 2110).

Although expressed as a member obligation, FINRA Rule 2010 also applies to associated persons. *See* FINRA MANUAL R. 0140(a) (2008) ("Persons associated with a member shall have the same duties and obligations as a member under the Rules.").

104 *See, e.g.*, Timothy Joseph Golonka, Compl. No. 2009017439601, 2013 FINRA Discip. LEXIS 5, at *22 (Fin. Indus. Regulatory Auth. Mar. 4, 2013) (decision); *see also* Birdthistle & Henderson, *supra* note 39, at 62 (noting that "[e]very violation of any other FINRA Rule is almost by definition a violation of Rule 2010").

105 Steven Robert Tomlinson, Disciplinary Proceeding No. 2009017527501, 2013 WL 2146659 (Fin. Indus. Regulatory Auth. Mar. 21, 2013) (hearing panel decision).

lates rules of legal conduct.[106] It requires fair dealing by registrants[107] and may be violated without a showing of bad faith or scienter.[108] FINRA invokes the rule both when other, more specific FINRA rules are violated and when no other rule is violated.[109] Accordingly, in some disciplinary matters, FINRA relies exclusively on its "just and equitable" rule to sanction misconduct.[110]

More specific FINRA rules govern investment bankers' conduct in a piecemeal fashion. They govern the use of "manipulative, deceptive or other fraudulent device[s];"[111] the suitability of advice provided to customers;[112] the "improper use of . . . [customers'] securities or funds;"[113] the conduct of outside business activities;[114] conflicts of interest in underwriting;[115] underwriting terms and arrangements;[116] re-

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106 *See id.* at *3 (citing with approval a statement by the SEC that the predecessor of FINRA Rule 2010 "'is not limited to rules of legal conduct but rather . . . states a *broad ethical principle* which implements the requirements of Section 15A(b)' of the Exchange Act" (omission in original)).

107 The rule requires that customers will be "dealt with fairly and in accordance with the standards of the profession." *Id.* at *3 (citing with approval *Timothy Joseph Golonka*, 2013 FINRA Discip. LEXIS 5, at *22).

108 *See id.* at *1 (explaining that Rule 2010 "broadly prohibits not just acts in bad faith, but also conduct inconsistent with ethical standards in the securities industry"); *see also* Gerald J. Kesner, Disciplinary Proceeding No. 2005001729501, 2008 WL 5385252, at *5 (Fin. Indus. Regulatory Auth. Aug. 15, 2008) (hearing panel decision) (contrasting the anti-fraud rules of the Securities Exchange Act and NASD Rule 2120—the predecessor of FINRA Rule 2020—with NASD Rule 2110—the predecessor of FINRA Rule 2010—and observing that "evidence of scienter is not required to establish that a misrepresentation and/or omission violated NASD Conduct Rule 2110").

Note also that, unlike a private litigant in an action under Section 10(b) or Rule 10b-5, "FINRA need not show reliance upon the alleged misrepresentation [or] omission." *Gerald J. Kesner*, 2008 WL 5385252, at *5 n.24 (citing Coastline Financial, Inc., No. C02950059, 1997 NASD Discip. LEXIS 9 (Nat'l Ass'n of Sec. Dealers Mar. 5, 1997) (decision)).

109 For the standalone use of FINRA Rule 2010 to sanction conduct by associated persons, see *infra* note 247 and accompanying text. *See also* Steven A. Ramirez, *The Professional Obligations of Securities Brokers Under Federal Law: An Antidote for Bubbles?*, 70 U. CIN. L. REV. 527, 547–48 (2002) (discussing the standalone use of the predecessor rule to FINRA Rule 2010).

A review of FINRA enforcement matters indicates that a violation of more specific rules also constitutes a violation of FINRA Rule 2010. According to the SEC, such an approach is "in accord with [its] long-standing and judicially-recognized policy that a violation of another [SEC] or NASD rule or regulation . . . constitutes a violation of [the predecessor of FINRA Rule 2010]." *See* Stephen J. Gluckman, 54 S.E.C. 175, 185 (1999).

110 For examples of such matters, see *infra* note 292 and accompanying text.

111 FINRA MANUAL R. 2020 (2008); *see also* FINRA MANUAL R. 2210 (2014) (essentially banning false or misleading statements in communications with the public).

112 *See* FINRA MANUAL R. 2111 (2014).

113 FINRA MANUAL R. 2150 (2010).

114 *See* FINRA MANUAL R. 3270 (2010).

115 *See* FINRA MANUAL R. 5121 (2014).

116 *See* FINRA MANUAL R. 5110 (2014).

strictions on the purchase and sale of securities in initial public offerings;[117] the provision of fairness opinions in M&A;[118] the provision of research analysts' reports;[119] private securities transactions of associated persons;[120] the implementation of anti-money laundering programs;[121] and compliance with information barriers.[122] Though numerous, these rules target fragments of investment bankers' conduct, albeit important ones, and are scattered through the FINRA Manual.

The bulk of FINRA's rules are directed at traditional broker-dealer activities, such as accepting customer orders to trade securities, and apply only incidentally to investment banking.[123] Nevertheless, the extraordinary breadth of the "just and equitable" rule provides FINRA with ample discretion to shape standards of investment bankers' conduct.

4. *Incidence and Magnitude of Misconduct*

In the public imagination, no other lawful industry is as synonymous with moral failure, deception, and public opprobrium as investment banking. Although these public sentiments are often exaggerated, investment banking firms may be especially prone to misconduct.[124] Many firms' organizational structures create opportunities and incentives for misconduct. Their organizational cultures may also promote self-interested behavior over other-regarding behavior, undermining efforts that may prevent or constrain misconduct. The structure and scale of pay for bankers exacerbate these various

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117 *See* FINRA MANUAL R. 5130 (2009), R. 6130 (2011).

118 *See* FINRA MANUAL R. 5150 (2008).

119 *See* NASD MANUAL R. 2711 (2008). See in particular NASD Rule 2711(b)(1), which provides that "no personnel engaged in investment banking activities may have any influence or control over the compensatory evaluation of a research analyst." NASD MANUAL R. 2711(b)(1) (2008); *see also* N.Y. STOCK EXCH. R. 472 (2013). These NASD and NYSE rules have yet to be consolidated into the FINRA Rulebook.

120 *See* NASD MANUAL R. 3040 (2004), R. 3050 (2002). These rules have yet to be consolidated into the FINRA Rulebook.

121 *See* FINRA MANUAL R. 3310 (2010).

122 *See* Memorandum from Nat'l Ass'n of Sec. Dealers to Members & Member Orgs., Chinese Wall Policies & Procedures 240 (June 21, 1991) (on file with The George Washington Law Review) (explaining the "minimum elements" for "adequate" Chinese walls).

123 For instance, the suitability obligation is almost invariably applied to traditional broker-dealer activities. Scholarly and judicial materials consider it in that context. Prominent scholarly treatments of broker-dealer regulation include COFFEE & SALE, *supra* note 51, at 632–705; COX ET AL., *supra* note 62, at 991–1037.

124 The term "investment banking firm" refers to those firms providing investment banking services, namely large financial conglomerates. *See supra* note 74. Obviously, not all criticisms of these firms relate to their investment banking activities.

forces, potentially fostering an environment ripe for the commission of misconduct. The industry is also vast; in 2012, for instance, U.S. investment bankers advised on 10,882 announced M&A transactions,[125] 4,981 debt offerings,[126] and 795 equity offerings,[127] generating altogether approximately $35 billion in fees.[128] The potential for harm is thus enormous.

Most investment banking firms are structured as financial conglomerates, providing numerous financial products and services and acting as both principals and agents.[129] This structure creates multiple opportunities for inadvertent conflicts of interest. Under agency law, for instance, investment banking firms must disclose material information in their possession to clients, protect nonpublic client information, and loyally serve client interests.[130] By statute, they must avoid

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125 THOMSON REUTERS, MERGERS & ACQUISITIONS REVIEW: FINANCIAL ADVISORS, FULL YEAR 2012, at 6 (2012), *available at* http://dmi.thomsonreuters.com/Content/Files/4Q2012_MA_Financial_Advisory_Review.pdf. This data relates to M&A transactions with any U.S. involvement. *See id.* According to figures compiled by Mergermarket, U.S. M&A activity for 2012 consisted of 3,711 transactions valued at $825.4 billion. *See* MERGERMARKET, M&A ROUND-UP FOR 2012, at 30 (2013), *available at* http://www.mergermarket.com/pdf/mergermarket_Legal_Advisor_Round_Up_2012.pdf. The differences between the data of Thomson Reuters and Mergermarket appear to relate to the criteria for inclusion of M&A transactions; for instance, Mergermarket excluded transactions valued at less than $5 million. MERGERMARKET, *supra*, at 55.

126 THOMSON REUTERS, DEBT CAPITAL MARKETS REVIEW: MANAGING UNDERWRITERS, FULL YEAR 2012, at 6 (2012), *available at* http://dmi.thomsonreuters.com/Content/Files/4Q2012_Global_Debt_Capital_Markets_Review.pdf.

127 THOMSON REUTERS, GLOBAL EQUITY CAPITAL MARKETS REVIEW: MANAGING UNDERWRITERS, FULL YEAR 2012, at 5 (2012), *available at* http://dmi.thomsonreuters.com/Content/Files/4Q12_Thomson_Reuters_Equity_Capital_Markets_Review.pdf.

128 These fees comprise approximately $17 billion from M&A advice, inclusive of Canadian deals, THOMSON REUTERS, *supra* note 125, at 8; $13.5 billion from debt securities offerings, THOMSON REUTERS, *supra* note 126, at 6; and $5.9 billion from equity securities offerings, THOMSON REUTERS, *supra* note 127, at 5.

129 For a description of the organizational structure of financial conglomerates, see Tuch, *supra* note 74, at 570–72.

130 As to the duty of disclosure, see RESTATEMENT (SECOND) OF AGENCY § 381 (1958); RESTATEMENT (THIRD) OF AGENCY § 8.11 (2006). The duty to keep nonpublic information disclosed by clients confidential arises under agency law. *See* RESTATEMENT (THIRD) OF AGENCY § 8.05 (2006). It may also arise under contract between a firm and its client. *Cf. id.* § 8.06(1) ("Conduct by an agent that would otherwise constitute a breach of duty . . . does not constitute a breach of duty if the principal consents . . . ."). The duty of loyalty is another incident of the principal-agent relationship. *See id.* § 8.01.

As an agent, the firm is duty bound to disclose material information in its possession to clients, provided that no "superior duty" would be violated in doing so. *See id.* § 8.11. Simultaneously, however, the financial conglomerate as agent is duty bound to keep confidential nonpublic information disclosed by its clients. *See id.* § 8.05 ("An agent has a duty . . . not to use or communicate confidential information of the principal for the agent's own purposes or those of a third party.").

trading on material nonpublic information.[131] These obligations are often incompatible and difficult to reconcile, which gives rise to inadvertent conflicts of interest and duty.[132]

For example, in disclosing information in discharge of a duty of disclosure to one client, investment banking firms may violate a duty of confidence to another client. They may even violate anti-fraud rules, exposing the firm to public enforcement action. Yet failing to disclose the information may violate the firm's duty of disclosure. Similarly, making a trade or investment in a principal capacity may place a firm in conflict with the interests of a client, violating its duty of loyalty to that client.

Incentives for intentional misconduct may increase the likelihood of violations. As advisors to clients, investment banking firms accumulate huge reservoirs of nonpublic information.[133] Such information—the currency in which Wall Street deals—may give firms an "edge" in their trading and investment activities.[134] Given the billions of dollars these activities generate for firms, the incentives to gain and exploit an "edge" may be especially strong.

Merger and acquisition activities of publicly traded companies may present particularly attractive opportunities and incentives for misconduct, as vast sums may be earned by those with knowledge of an impending, yet-to-be-announced deal.[135] The well-documented

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131 Under Section 10(b) of the Exchange Act and associated Rule 10b-5, firms owe public investors a duty to abstain from trading using material nonpublic information. *See* 15 U.S.C. § 78j(b) (2012); 17 C.F.R. § 240.10b-5 (2014).

132 *See* Norman S. Poser, *Chinese Wall or Emperor's New Clothes? Regulating Conflicts of Interest of Securities Firms in the U.S. and the U.K.*, 9 MICH. Y.B. INT'L LEGAL STUD. 91, 95 (1988) ("[C]onflicts of interest and of duty . . . are endemic to a multi-service firm."); Tuch, *supra* note 74, at 572–81 (discussing the irreconcilable duties financial conglomerates may owe); *see also* S. REP. NO. 111-176, at 91 (2010) (providing Paul Volcker's description of conflicts of interest as "inherent in the participation of [financial conglomerates] in proprietary or private investment activity"); STIGLITZ, *supra* note 4, at 158 ("The problems [of conflicts of interest] are endemic to the banking industry, and have long been recognized.").

133 Investment banking firms are repositories of vast amounts of material nonpublic information from clients, which may be used for personal or institutional benefit. *See* GEISST, *supra* note 61, at 199 ("As advisors, [investment bankers] are privy to otherwise secret information that could quickly change the price of a company's stock."); *see also* GOLDMAN SACHS, 2012 ANNUAL REPORT inside front cover (2012), *available at* http://www.goldmansachs.com/s/2012annual/assets/downloads/GS_AR12_AllPages.pdf ("We regularly receive confidential information as part of our normal client relationships.").

134 Investors may also gain an edge from information they gain as principals in trading and other markets. But the edge may also come from serving the interests of clients. For a discussion of the "edge" large diversified investment banking firms have over other market participants, see AUGAR, *supra* note 66, at 107–19.

135 The issue of investment banking firms trading ahead of deals has attracted regulatory

phenomenon of target shareholders earning significant abnormally positive returns from M&A deals exacerbates such incentives.[136]

The organizational cultures of many investment banking firms may also promote misconduct.[137] In its 2013 report on the banking industry, the U.K. Parliamentary Commission on Banking Standards observed that, although the "world of investment banking may have seemed mysterious, even glamorous[,] . . . in recent times, shockingly poor standards and culture have been revealed."[138] The Commission described banks as having an "individualistic, bonus-driven ethos"[139] and as pursuing revenue "at all costs."[140] The Commission noted that "the idea of fiduciary obligation to customers was ebbing away."[141] In

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concern. *See, e.g.*, Jenny Anderson, *S.E.C. Is Looking at Stock Trading*, N.Y. TIMES (Feb. 6, 2007), http://www.nytimes.com/2007/02/06/business/06wall.html (asserting that the "Securities and Exchange Commission has begun a broad examination into whether Wall Street bank employees are leaking information" and that "[c]oncerns about insider trading have escalated as mergers and buyouts have boomed").

136 As to early empirical evidence of target shareholders earning abnormal returns, see generally Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983).

137 The description of investment banking firms' organizational culture below is drawn primarily from two sources—Karen Ho and The U.K. Parliamentary Commission on Banking Standards. *See* UK PARLIAMENTARY BANKING REPORT, *supra* note 4; HO, *supra* note 24. Both generally conceptualize organizational culture in terms of firms' practices, norms, and values. They focus on the workplace lives of investment bankers, as distinct from those of firms' senior managers. Karen Ho describes her conception of culture as focused in particular on "what [her] informants have deemed central to understanding their organizational milieu." HO, *supra* note 24, at 215. The brief description here of organizational culture in investment banking is necessarily incomplete.

Though culture varies by firm, the frequency of lateral movement by bankers among firms suggests much uniformity. As to the increased willingness in recent decades for investment bankers to change firms, rather than spend their entire careers at a single firm as had been the norm, see *id.* at 267–70, which discusses the mobility of investment bankers in the 1990s and 2000s, and MORRISON & WILHELM, *supra* note 62, at 281–87, which notes the barriers that restricted investment bankers' mobility in the 1950s and 1960s.

138 UK PARLIAMENTARY BANKING REPORT, *supra* note 4, at 99.

139 *See id.* at 135–36 (quoting John Plender & Delphine Strauss, *How Traders Trumped Quakers*, FIN. TIMES, July 7, 2012, at 7). The report refers to both banking generally and to investment banking in particular. The report studies firms that engage in investment banking activities, although it often refers to these firms simply as "banks" or to the industry as the "banking" or "financial" industry. Not all of the criticisms of these firms are directed at the investment bankers they employ, but reflect on the firms generally.

140 *See id.* at 136. Some commentators point to weak job security in investment banking as creating incentives for bankers to "make as much money as quickly as possible." REYNOLDS & NEWELL, *supra* note 4, at 4–5; *see also* HO, *supra* note 24, at 257 ("[C]ollectively, [the] overwhelming concerns [of investment bankers] were with money and compensation via bonuses.").

141 UK PARLIAMENTARY BANKING REPORT, *supra* note 4, at 135 (quoting John Plender & Delphine Strauss, *How Traders Trumped Quakers*, FIN. TIMES, July 7, 2012). See also *id.* at 131–32 for a discussion of the decline in loyalty.

addition, few bankers felt a duty to monitor their colleagues' conduct, and there was "an absence of any sense of duty to the customer and a similar absence of any sense of collective responsibility to uphold the reputation of the industry."[142] Those committing misconduct did not need to be discreet, the Commission observed, and bankers asked what they could "get away with," rather than "what is right."[143] The Commission also characterized banks as hostile to whistleblowers and as operating by a "code of silence" in which unethical behavior could not be reported "without fear of reprisal."[144]

Although the Commission examined banking conduct in the U.K., the major actors—even in the U.K.—are U.S. firms,[145] and evidence about the culture of investment banking firms in the United States appears consistent. Anthropologist Karen Ho described investment banking culture in the United States as having a generalized norm of "reckless expediency"[146] and an institutional imperative to "'milk' as much out of the present as possible, regardless of [the] consequence[s]."[147] Another commentator described U.S. investment banking firms as having shifted "to a more aggressive, opportunistic, and transactional business model."[148] Scholars have documented how U.S. investment banking firms have become less loyal to their clients,[149] and are less concerned about preserving their reputations for propriety.[150]

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142 *Id.* at 138. For a similar analysis, see Ho, *supra* note 24, at 285–94 (discussing how investment banking culture gives rise to self-interested behavior by investment bankers).

143 *See id.* at 136 (quoting one person interviewed).

144 *See id.* at 366 (quoting one person interviewed). The Commission quotes the testimony of one former investment banker that "[b]ankers who object to unethical practices, or simply to excessive risk, will be labelled as trouble-makers or just treated as 'not a team player.'" *Id.* at 137.

145 *See* PHILIP AUGAR, CHASING ALPHA: HOW RECKLESS GROWTH AND UNCHECKED AMBITION RUINED THE CITY'S GOLDEN DECADE 119–30 (2009) (discussing the dominance of New York-headquartered investment banking firms in London from the late 1990s).

146 *See* HO, *supra* note 24, at 285.

147 *Id.* at 290.

148 JONATHAN A. KNEE, THE ACCIDENTAL INVESTMENT BANKER: INSIDE THE DECADE THAT TRANSFORMED WALL STREET xvi (2006).

149 *See* ROBERT G. ECCLES & DWIGHT B. CRANE, DOING DEALS: INVESTMENT BANKS AT WORK 55–58 (1988) (discussing the more "transaction-oriented" and less "relationship-oriented" relationships between investment banking firms and their clients).

150 *See* Alan D. Morrison et al., Investment-Banking Relationships: 1933–2007, at 30–35 (Jan. 8, 2014) (unpublished manuscript), *available at* http://ssrn.com/abstract=2376481 (presenting evidence on the diminishing willingness of clients, beginning around the 1960s, to reengage investment banking firms to underwrite securities offerings, and commenting on the weakening force of investment banking reputations for propriety in constraining conflicts of interest and other misconduct).

Finally, the structure and scale of investment bankers' pay may magnify all of these incentives for misconduct. Indeed, much evidence has linked bankers' pay to misconduct and other undesirable practices.[151] Though performance-based, bankers' pay was (and often still is) tied to financial measures that often encourage bankers to focus on the short-term consequences of their conduct.[152] In addition, bankers generally face potentially unlimited upside return on deals, but limited downside loss.[153] Karen Ho explained that such pay practices create asymmetrical incentives for investment bankers to generate quick, short-term rewards; to the investment banker, the "single-minded pursuit of deals is necessary to extract massive short-term profits before the boom turns to bust."[154]

The quantum of pay on offer to bankers is also staggeringly large, potentially swaying the conduct of even those individuals who are generally committed to propriety. Though the lavish pay and its asymmetric structure may not lead bankers to commit outright fraud, it may lead them to promote their self interest over clients' interests—conduct that may harm clients and is often difficult to detect.[155] Because many individuals are drawn to investment banking for the high

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151 *See, e.g.*, UK PARLIAMENTARY BANKING REPORT, *supra* note 4, at 126 (noting that "distorted incentives . . . contribute to poor prudential and conduct standards"); REYNOLDS & NEWELL, *supra* note 4, at 4 ("It is clear that incentives in the form of the high levels of pay received by investment bankers . . . was a contributing factor to the financial crisis."); Dan Awrey, William Blair & David Kershaw, *Between Law and Markets: Is There a Role for Culture and Ethics in Financial Regulation?*, 38 DEL. J. CORP. L. 191, 231–32 (2013) (noting that compensation arrangements lead to excessive risk taking).

152 *See* UK PARLIAMENTARY BANKING REPORT, *supra* note 4, at 130 (noting that the calculation of pay in investment banking at the "top banks" was "thoroughly dysfunctional" and provided incentives for individuals "to be preoccupied with short-term leveraged growth rather than sustainability and good conduct"); John C. Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1047 (2012) ("Because a rapid shift towards incentive-based compensation at financial institutions focused senior management on short-term results, longer-term risks were ignored or excessively discounted."); *Bankers' Bonuses: Tilting the Playing Field*, ECONOMIST, Mar. 9, 2013, at 72–73 (discussing the "slippery tricks" in which banks engaged and the contribution of banks' bonus culture); Peter Eavis, *Regulators Size Up Wall Street, With Worry*, N.Y. TIMES, Mar. 13, 2014, at B1 ("Wall Street's compensation practices can reward unhealthy levels of short-term risk-taking and entice bankers into ethical lapses.").

153 *See* HO, *supra* note 24, at 284 ("[I]nvestment bankers . . . share the gains but not the losses . . . ." (internal quotation marks omitted)).

154 *Id.* at 295.

155 *See id.* at 290 ("Given that bonuses depends [sic] on the size, amount, and number of deals that bankers bring in . . . bankers are structurally primed to generate as many deals as possible whether or not these deals are ultimately 'good' for the company . . . .").

pay, they may be more likely to succumb to financial temptation than individuals primarily motivated by other factors.[156]

Against this institutional backdrop, it is unsurprising to find documented instances of misconduct within the investment banking industry over the past fifteen years. The bursting of the dot-com bubble at the turn of the century revealed investment banking practices of "spinning" and "laddering."[157] The aftermath of the dot-com bubble also revealed widespread skewing of research by research analysts at investment banking firms.[158] The collapse of Enron revealed fraud by investment bankers in helping executives disguise their activities from investors.[159] During the financial crisis of 2008, investment banking firms were accused of deceiving investors in mortgage-backed securities and selling faulty financial products.[160] Investment banking firms

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156 Based on her field study in investment banking, anthropologist Karen Ho concluded that "money was usually regarded as the most important [factor]" in explaining why investment bankers worked in the industry. *Id.* at 257. She asserts that interviewers would disbelieve candidates who claimed that "money" was not their "primary reason for working at an investment bank." *Id.* at 258.

157 The practice of "spinning" involves financial institutions allocating shares in "hot" initial public offerings ("IPO") to directors to induce them to direct future business to the financial institution. *See In re* eBay, Inc. S'holders Litig., No. C.A. 19988-NC, 2004 WL 253521, at *1 (Del. Ch. Feb. 11, 2004). Laddering involves financial institutions allocating shares in "hot" IPOs to investors on the understanding that those investors will purchase further shares in aftermarket trading. For a general description of such practices, see STIGLITZ, *supra* note 4, at 140–69. For legal analysis, see Therese H. Maynard, *Spinning in a Hot IPO—Breach of Fiduciary Duty or Business as Usual?*, 43 WM. & MARY L. REV. 2023 (2002); Harry McVea, *"Laddering", "Spinning" and "Hot" IPOs—Assessing the Regulatory Implications*, 25 COMPANY LAW. 303 (2004).

158 For a description of research analyst practices during the dot-com boom, see Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035, 1040 (2003).

159 *See* AUGAR, *supra* note 66, at 125–26. The conduct of investment bankers in events leading to the collapse of Enron was detailed in a report by court-appointed examiner Neal Batson. *See* Third Interim Report of Neal Batson, Court-Appointed Examiner, *In re* Enron Corp., No 01-16034 (AJG), 2003 WL 22319021 (Bankr. S.D.N.Y. June 30, 2003). For a detailed description of investment bankers' conduct and an assessment of their potential liability in the Enron collapse, based on the examiner's report and other evidence, see Hillary A. Sale, *Banks: The Forgotten(?) Partners in Fraud*, 73 U. CIN. L. REV. 139, 142 (2004). Bankers' conduct in the collapse of WorldCom aroused similar concerns. *See id.* at 143.

160 *See, e.g.*, STAFF OF S. COMM. ON HOMELAND SEC. & GOV'T AFFAIRS, PERMANENT SUBCOMM. ON INVESTIGATIONS, 111TH CONG., REP. ON WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE 318–636 (Comm. Print 2011) (detailing, by way of case studies, "investment bank abuses" in the lead-up to the financial crisis, including failing to disclose material adverse information and making unsuitable investment recommendations); FIN. CRISIS INQUIRY COMM'N, *supra* note 71, at 224–26 (discussing "deficiencies" in disclosures by underwriters of mortgage-backed securities and other products that collapsed in value as housing markets deteriorated).

have also been implicated in money laundering[161] and the systematic manipulation of the London Interbank Offered Rate ("LIBOR"), the rate to which the interest rates in many financial contracts are pegged.[162] All of these events led the U.K. Parliamentary Commission on Banking Standards to assert not only that the banking industry was "incompetent," but also that it "appeared morally bankrupt."[163] William C. Dudley, President of the Federal Reserve Bank of New York, also remarked that "[t]here is evidence of deep-seated cultural and ethical failures at many large financial institutions."[164]

Moreover, systematic empirical evidence suggests that some investment bankers regularly exploit nonpublic information garnered from their investment banking clients, conduct that may harm clients and even third parties.[165] In a study of M&A deals involving publicly traded companies for the twenty-year period ending in 2003, Andriy Bodnaruk and his coauthors found that investment banking firms advising bidders in M&A transactions earned abnormally positive returns when trading in the stocks of target corporations.[166] In addition, the probability of a company becoming an M&A target was strongly correlated with the stakes investment banking firms held in companies. Companies in which investment banking firms or their affiliates held stakes were forty-five percent more likely to become M&A targets than other companies.[167] The authors ruled out benign explanations for the findings, including the possibility of superior trading ability on the part of investment banking firms advising bidders.[168]

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161 *See* Eavis, *supra* note 152 ("Money laundering, market rigging, tax dodging, selling faulty financial products, trampling homeowner rights and rampant risk-taking—these are some of the sins that big banks have committed in recent years.").

162 *See Lloyds Fined £218m over Libor Rate Rigging Scandal*, BBC (July 28, 2014), http://www.bbc.com/news/business-28528349 ("Lloyds manipulated the [LIBOR] for yen and sterling . . . .").

163 *See* UK PARLIAMENTARY BANKING REPORT, *supra* note 4, at 82.

164 *See* Eavis, *supra* note 152.

165 The misuse of nonpublic information may harm third parties by lowering market liquidity, increasing trading costs, raising the cost of equity capital, and increasing volatility. *See, e.g.*, Viral V. Acharya & Timothy C. Johnson, *Insider Trading in Credit Derivatives*, 84 J. FIN. ECON. 110, 134 (2007).

166 *See* Andriy Bodnaruk, Massimo Massa & Andrei Simonov, *Investment Bankers as Insiders and the Market for Corporate Control*, 22 REV. FIN. STUD. 4989, 4990 (2009). *But see* John M. Griffin, Tao Shu & Selim Topaloglu, *Examining the Dark Side of Financial Markets: Do Institutions Trade on Information from Investment Bank Connections?*, 25 REV. FIN. STUD. 2155, 2163, 2185 (2012) (finding, based on NASDAQ trading records, limited exploitation of nonpublic information by investment banking firms during the period from 1997 to 2002).

167 *See* Bodnaruk et al., *supra* note 166, at 5001–03.

168 *See id.* at 5009–16. The authors show that the trading performances of investment banking firms advising bidders significantly outperform alternative strategies, including investment

Narasimhan Jegadeesh and Yue Tang similarly found that investment banking firms exploited nonpublic information obtained from their M&A clients by leaking it to their brokerage clients during the period from 1998 to 2008.[169] Other studies provide supporting evidence, finding that investment banking firms often exploit nonpublic client information acquired from their lending clients.[170]

Empirical evidence also suggests that some investment banking firms skew their advice to M&A clients, serving their own interests rather than their clients' interests.[171] Bodnaruk and his coauthors suggest that some M&A advisors to bidders provided advice to advance their own interests, leading to inferior deal outcomes for their clients as compared with clients of unconflicted investment banking firms.[172] Similarly, a recent study by Jay Ritter and Donghang Zhang suggests that lead underwriters during buoyant markets tend to preferentially

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banking firms' own performances when trading in target companies about which they lack nonpublic information. *See id.* at 5016–18.

169 *See* Narasimhan Jegadeesh & Yue Tang, Institutional Trades Around Takeover Announcements: Skill vs. Inside Information 1 (Dec. 1, 2010) (unpublished manuscript), *available at* http://ssrn.com/abstract=1568859. In particular, the institutional trading clients of investment banking firms engaged to advise targets were net buyers of target shares before deals were publicly announced, and their (clients') pre-announcement trades were significantly profitable. *See id.* at 4–5, 15–19. In comparison, clients of investment banking firms not engaged as M&A advisors failed to earn significant profits in pre-announcement trading. The authors found no evidence that advisors to bidders exploited nonpublic information in their trading activities.

The study by Jegadeesh and Tang specifically examines potential information leaks to clients by the brokerage arms of investment banking firms advising either bidders or targets. In comparison, the study by Bodnaruk et al., *supra* note 166, examines potential information leaks within investment banking firms, from M&A advisory segments to the trading or asset management segments of the firms themselves, but not to clients of those segments.

170 *See* Viral V. Acharya & Timothy C. Johnson, *Insider Trading in Credit Derivatives*, 84 J. Fin. Econ 110 (2007) (finding financial conglomerates exploited nonpublic information garnered from lending clients in their trading in credit default swaps); Victoria Ivashina & Zheng Sun, *Institutional Stock Trading on Loan Market Information*, 100 J. Fin. Econ. 284, 302 (2011) (finding financial conglomerates and other institutional investors exploited nonpublic information garnered from lending clients (i.e., borrowers) in equity trading); Massimo Massa & Zahid Rehman, *Information Flows Within Financial Conglomerates: Evidence from the Banks—Mutual Funds Relation*, 89 J. Fin. Econ. 288, 304 (2008) (finding financial conglomerates exploited nonpublic information garnered from lending clients in their mutual fund investing).

171 Skewed advice may give rise to suboptimal deal outcomes for clients, or costly monitoring by clients. *See, e.g.*, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305, 308–10 (1976) (discussing bonding and monitoring costs and other "agency costs" arising from the divergence of interests between principals and their agents).

172 *See* Bodnaruk et al., *supra* note 166, at 4992 (suggesting that investment banking firms "induce bidders to enter wealth-destructive deals for their own interests"); *id.* at 5016–24 (finding that clients pay higher premiums and overpay for target companies in which their investment banking advisors have a stake).

allocate stock in "hot" initial public offerings to their affiliated mutual funds rather than other investors.[173]

Recent decisions of the Delaware Court of Chancery bolster this empirical evidence of misconduct. In a suit against directors of Rural Metro Corporation over its sale, the court criticized the conduct of an investment banking firm that advised the target in a proposed transaction while simultaneously—and secretly—seeking to provide funding to a potential bidder.[174] The court described as "egregious" the firm's failure to disclose to its client its "fevered efforts" to fund the acquisition by the purchaser.[175] It admonished the firm for disclosing its client's "inside information" to that purchaser,[176] and it concluded that the firm had misled its client's directors, leading them to violate their fiduciary duties.[177]

In the sale of Del Monte Foods Company, the court took to task an investment banking firm advising the seller that met surreptitiously with potential bidders to engineer the sale of its client.[178] Even when the client decided it was not for sale and instructed the firm to "shut down" the sale process,[179] the investment bankers continued to meet secretly with potential bidders, orchestrating a proposed joint bid in violation of confidentiality agreements earlier required by the client.[180] The court characterized such conduct as "illicit behavior [that] is secretive and subversive, yet appears to elicit yawns from Wall Street players who regard it as par for the course."[181]

Additional decisions highlight multiple other forms of misconduct.[182] For example, with respect to the sale of El Paso Corpora-

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173 *See* Jay R. Ritter & Donghang Zhang, *Affiliated Mutual Funds and the Allocation of Initial Public Offerings*, 86 J. FIN. ECON. 337, 367 (2007). The buoyant market period studied was 1999–2000. *See id.*

174 *See In re* Rural Metro Corp., 88 A.3d 54, 100 (Del. Ch. 2014).

175 *See id.*

176 *See id.* at 95, 101–03.

177 *See id.* at 99–100.

178 *See In re* Del Monte Foods Co. S'holders Litig., 25 A.3d 813, 819 (Del. Ch. 2011).

179 *See id.* at 822.

180 *See id.* at 833 ("Barclays paired up Vestar and KKR in violation of their confidentiality agreements with Del Monte."). The court summarized the bank's conduct as "secretly and selfishly manipulat[ing] the sale process to engineer a transaction that would permit Barclays to obtain lucrative buy-side financing fees." *Id.* at 817.

181 *Id.* at 842.

182 *See* Ortsman v. Green, C.A. No. 2670-N, 2007 WL 702475, at *1 (Del. Ch. Feb. 28, 2007) (ordering expedited discovery where an investment banking firm that was both advising the target and preparing to provide buy-side financing allegedly discouraged the target from pursuing an indication of interest from a strategic buyer that would not require financing); *In re* Prime Hospitality, Inc. S'holders Litig., No. Civ.A. 652-N, 2005 WL 1138738, at *4 (Del. Ch. May 4,

tion,[183] the court questioned the integrity of the information barriers an investment banking firm employed to minimize the firm's conflicts of interest;[184] the bank had been engaged to advise the target on its proposed sale, despite holding a $4 billion stake in the bidder and controlling two of the bidder's board seats.[185] The court also criticized the lead investment banker for failing to disclose his personal shareholding in the bidder, describing his conduct as "a very troubling failure that tends to undercut the credibility of [that banker's] testimony and of the strategic advice he gave," thus "heightening . . . suspicions" about the investment bank's conduct.[186]

In a suit against the directors of Southern Peru Copper over its acquisition of a related company, the court disparaged an investment bank's preparation of its fairness opinion.[187] The court described the firm as "focus[ed] on finding a way to get the terms of the Merger structure . . . to make sense, rather than aggressively testing the assumption that the Merger was a good idea in the first place,"[188] thereby "undermin[ing] the . . . argument that the process . . . was fair"[189] and lending credence to arguments that the process leading to the merger was "an exercise in rationalization."[190] The court also questioned the firm's loyalty to its client.[191]

The harms arising from all of this investment banking misconduct, though impossible to estimate precisely, are likely considerable given the number and magnitude of deals on which investment bankers advise—many involving tens of billions of dollars.[192] Skewed advice by bankers to M&A clients may lead to value-destroying deals,

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2005) (questioning an investment banker's failure to disclose whether his firm had been "actively facilitating deals" for a potential buyer of a company it had been retained by, and indicating that the firm had been too slow in disclosing the conflict of interest).

183 *In re* El Paso Corp. S'holder Litig., 41 A.3d 432 (Del. Ch. 2012).

184 *See id.* at 440 ("Although it is true that measures were taken to cabin Goldman's conflict . . . those efforts were not effective.").

185 *Id.* (noting that Goldman "had a 'potential conflict' because: (1) it owned . . . $4 billion worth of . . . [the bidder's] stock; [and] (2) it controlled two of [the bidder's] board seats" (footnote omitted)).

186 *Id.* at 442.

187 *See In re* S. Peru Copper Corp. S'holder Derivative Litig., 52 A.3d 761, 795 (Del. Ch. 2011).

188 *Id.* at 801.

189 *Id.*

190 *See id.*

191 *See id.* at 804 (stating that the investment banking firm had not served its client's interests "ideally").

192 *See supra* notes 125–28 and accompanying text (providing data regarding investment banking transactions).

leaving combined entities and their stakeholders weaker than if no deal had occurred. Such skewed advice may increase bonding and monitoring costs for clients who are cautious of their bankers; some clients may, for instance, engage multiple advisors as crosschecks and employ internal experts to monitor bankers' conduct. Skewed advice may also lead to unnecessary transaction costs, including the fees paid to investment bankers and other advisors, as well as litigation costs. The misuse of material nonpublic client information by bankers may also reduce market liquidity, increase trading costs, increase the cost of equity capital and volatility, and possibly reduce the accuracy of stock prices.[193] Empirical evidence is mixed on whether M&A systematically results in efficiency gains, strongly suggesting, therefore, that some deals are wealth destroying.[194] Empirical evidence also suggests that certain types of mergers create anticompetitive harms.[195] The evidence does not discriminate between deals based on whether they resulted from the skewed advice of bankers or other factors. But even if a small proportion of bad deals was linked to investment bankers' misconduct, the losses would likely be significant, given the magnitude of many deals—and their sheer volume.[196]

II. Enforcement of Self-Regulation

Part I established that investment bankers are broker-dealers, identified the FINRA rules to which they are subject, and provided evidence suggesting that misconduct may pervade the investment

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193 *See* Acharya & Johnson, *supra* note 165, at 114 ("Insider trading has been the focus of a large body of research in equity markets which has found that insider trading lowers liquidity and increases trading costs, raises the cost of equity capital, and increases volatility." (citations omitted)); Merritt B. Fox, *Insider Trading in a Globalizing Market: Who Should Regulate What?*, 55 Law & Contemp. Probs. 263, 263, 277, 282–83 (1992) (arguing that insider trading reduces share price accuracy, which in turn may lead to inefficiency by "reduc[ing] the likelihood that resources will be allocated to implement the most promising real investment projects available in the economy," by decreasing the feasibility of executive compensation based on securities prices, and by "undermin[ing] the market for corporate control"). For further discussion of the potential third party harms of the misuse of nonpublic information by corporate advisors, see Tuch, *supra* note 74.

194 *See* Lars-Hendrik Röller et al., *Efficiency Gains from Mergers* 34, 50–53 (The Research Inst. of Indus. Econ., Working Paper No. 543, 2000), *available at* http://swopec.hhs.se/iuiwop/papers/iuiwop0543.pdf (summarizing empirical evidence on the efficiency gains and anticompetitive effects of mergers); *see also* Sandra Betton et al., *Corporate Takeovers*, *in* 2 Handbook of Corporate Finance: Empirical Corporate Finance 291, 375, 389 (B. Espen Eckbo ed., 2008) (concluding that "the typical merger produces significantly positive combined announcement-induced abnormal stock returns to bidders and targets," but noting evidence of postmerger underperformance).

195 *See* Röller et al., *supra* note 194, at 34.

196 For data on the magnitude and volume of deals in 2012 alone, see *supra* notes 125–28.

banking industry. This Part explains the methods FINRA uses to enforce its rules and presents evidence of the extent to which it enforces those rules against investment bankers—and against firms for the conduct of investment bankers.

A. Methods

FINRA enforces compliance by members and their associated persons with its own rules (and those of its predecessor organizations), and with the Exchange Act and related rules.[197] In doing so, FINRA exercises investigatory, prosecutory, and adjudicatory functions and imposes sanctions that include fines, censures, and suspensions or disbarments.[198] FINRA may also order broker-dealers and associated persons to provide restitution to those they have wronged.[199]

FINRA uses two common disciplinary procedural routes to impose sanctions. Represented in Figure 1 below, the routes diverge depending on whether FINRA issues a complaint. They must be considered in order to understand the methodological approach used in this Article to assess the deterrence force of FINRA's enforcement activity.

Under the first procedural route, FINRA formally commences a disciplinary matter by issuing a complaint alleging a rule violation.[200] The matter is then either adjudicated by a FINRA disciplinary panel or settled.[201] If adjudicated, the Office of Hearing Officers issues a decision, which may be appealed—by either FINRA or the respondent—to FINRA's National Adjudicatory Council.[202] That determination is subject to de novo review by the SEC,[203] and an SEC order

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197 *See* SEC BROKER-DEALER STUDY, *supra* note 79, at A-7. FINRA also enforces rules of the Municipal Securities Rulemaking Board. *See id.*

198 More specifically, FINRA may sanction its members or their associated persons by "expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction." 15 U.S.C. § 78o-3(b)(7) (2012).

199 *See* FIN. INDUS. REGULATORY AUTH., SANCTION GUIDELINES 4 (2013), *available at* http://www.finra.org/web/groups/industry/@ip/@enf/@sg/documents/industry/p011038.pdf.

200 FINRA MANUAL R. 9211 (2008).

201 Black, *supra* note 23, at 47–48 (reviewing monthly FINRA matters for 2008 and noting that all were either settled or adjudicated).

202 *See* FINRA MANUAL R. 9231 (2014); FINRA MANUAL R. 9312(a)(1)–(2) (2012) (allowing certain appeals to be reviewed by the National Adjudicatory Council).

203 As a self-regulatory organization, FINRA must inform the SEC of any final disciplinary action it takes; that action is then reviewable by the SEC, either on its own motion or the motion of a person aggrieved. *See* 15 U.S.C. § 78s(d)(2); *see also* Black, *supra* note 23, at 28 ("All [FINRA] disciplinary proceedings are subject to de novo review by the SEC . . . .").

is, in turn, subject to judicial review by the federal courts of appeals.[204] If the matter settles, the parties execute an Order Accepting Offer of Settlement, under which the respondent consents to the entry of findings and violations and to the imposition of sanctions.[205]

Under the second, more commonly adopted route, FINRA initiates a matter without issuing a complaint.[206] The first public notice of such a disciplinary matter occurs when FINRA announces a settlement with a respondent. That is to say, FINRA settles such matters without issuing a complaint or otherwise publicly commencing the matter. Public notice occurs only on settlement.[207] Under the settlement agreement, the respondent consents to the entry of findings and violations and to the imposition of sanctions.[208] Necessarily, each disciplinary matter so settled involves the imposition of a sanction.[209] If a matter fails to settle, FINRA gives no public notice, but it would then have the option of either issuing a complaint or not pursuing the matter further.

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204 *See* 15 U.S.C. § 78y(a)(1).

205 Under the terms of the settlement, the respondent typically neither admits nor denies wrongdoing. *See, e.g.*, FINRA Manual R. 9270 (2008) (laying out the procedure for FINRA settlements); Order Accepting Offer of Settlement at 1, Oppenheimer & Co., Inc., Disciplinary Proceeding No. 2009018668801 (Fin. Indus. Regulatory Auth. Aug. 5, 2013), *available at* http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p315930.pdf (an example of an Order Accepting Offer of Settlement whereby the respondent neither admits nor denies wrongdoing).

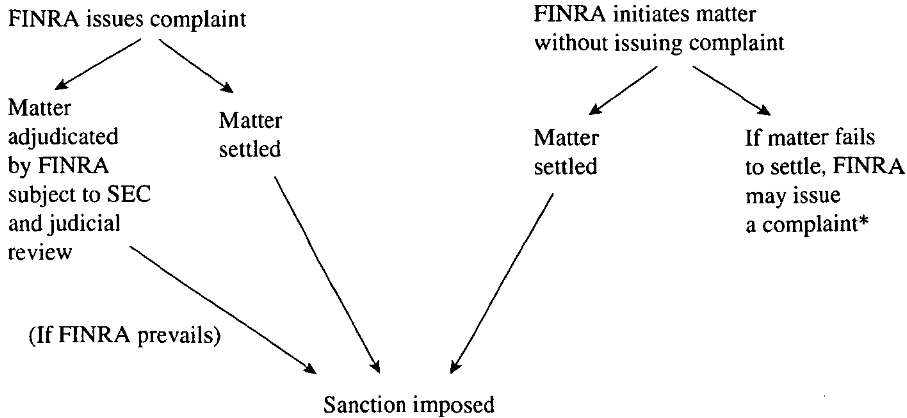
206 *See* Black, *supra* note 23, at 47–48.

207 *See* FINRA Manual R. 8313 (2013). The practice involves the respondent submitting a Letter of Acceptance, Waiver, and Consent ("AWC") that sets out factual findings and alleged rule violations and proposes settlement of those violations. FINRA Manual R. 9216 (2008). By accepting it, the National Adjudicatory Council, Review Subcommittee, or Office of Disciplinary Affairs causes the letter to be deemed the complaint, answer, and decision in the matter. *See id.*

208 The respondent also neither admits nor denies wrongdoing and waives its rights to have a complaint issued specifying the allegations against it. Virtually every AWC contains the following language: "The firm hereby accepts and consents, without admitting or denying the findings, and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of FINRA, or to which FINRA is a party, prior to a hearing and without an adjudication of any issue of law or fact, to the entry of the following findings by FINRA[.]" *See, e.g.*, Letter of Acceptance, Waiver & Consent No. 20100215959-02 from Spartan Sec. Grp., LTD. to Dep't of Market Regulation, Fin. Indus. Regulatory Auth. (Apr. 21, 2014), *available at* http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=36265. The language in an Order Accepting Offer of Settlement is similar. *See, e.g.*, Order Accepting Offer of Settlement, *supra* note 205, at 1.

209 *See supra* note 208 and accompanying text.

FIGURE 1. PROCEDURAL ROUTES LEADING TO SANCTIONS BY FINRA AGAINST ITS MEMBERS AND THEIR ASSOCIATED PERSONS



* If FINRA issues a complaint, it would then follow the alternative procedural route, which may lead to the imposition of a sanction.

This study examines only disciplinary matters resolved by FINRA that resulted in the imposition of a sanction. The main alternative—focusing on matters commenced by FINRA—would produce a significantly incomplete data set, because the majority of FINRA's disciplinary matters follow the second procedural route. That is, they are never publicly commenced and are only publicized on settlement. Because FINRA's deterrence force is likely to come primarily from the disciplinary matters it resolves with the imposition of a sanction, rather than those it commences, the methodology employed captures the variable under consideration—FINRA's deterrence force.[210]

B. *Intensity*

This section examines FINRA's regulatory intensity for the period from January 1, 2008 to June 30, 2013.[211]

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210 Even if FINRA commenced substantially more matters that were resolved in its favor and thus devoted further resources to investment bankers' conduct, one could not infer greater deterrence than that reflected in the reported data in this Part. The matters FINRA commenced but failed to resolve successfully could represent weak cases (that FINRA rightly decided against pursuing) or strong cases (that FINRA wrongly decided against pursuing). Neither type of matter would likely have significant deterrence effect.

211 The term "regulatory intensity" encompasses enforcement activity levels. *See* Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*, 24 YALE J. ON REG. 253, 256 (2007).

1. Methodology

The objective was to identify every FINRA disciplinary matter resolved with the imposition of a sanction against an investment banker or a firm for an investment banker's conduct.[212] In the former category, the respondents are individuals (invariably registered as associated persons); in the latter, they are firms (and registered as members).[213] Investment bankers are those individuals described by FINRA (in the relevant adjudicatory or settlement materials) as investment bankers, as working in the investment banking division or unit of a broker-dealer or member firm, or as performing any of the investment banking functions described above—namely advising on M&A, securities offerings, or corporate restructurings.[214]

The study identified disciplinary matters reported in the five-and-one-half-year period under review; FINRA's monthly enforcement reports detailing all disciplinary matters on a monthly basis were examined for the relevant period.[215] The reports were searched

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212 The Article excludes matters brought by FINRA to enforce rules of the Municipal Securities Rulemaking Board ("MSRB"), a self-regulatory body that regulates firms engaging in municipal securities and advisory activities. These matters were excluded to contain the scope of the study and because FINRA does not promulgate MSRB rules.

213 FINRA disciplinary matters against firms are considered because of a firm's ability to deter misconduct by the investment bankers they employ by, for instance, establishing and enforcing robust control mechanisms and shifting sanctions imposed on firms to the individuals responsible.

214 *See supra* Part I.B.1. In this Article, research analysts are regarded as investment bankers if they were sanctioned for performing an investment banking function, such as soliciting investment banking business. For an example of such a matter, see Letter of Acceptance, Waiver & Consent No. 2011026060504 from Joey Giamichael to Dep't of Enforcement, Fin. Indus. Regulatory Auth. (Sept. 7, 2012).

215 FINRA publishes monthly reports that list or summarize all of its resolved disciplinary matters. *See, e.g.*, *2013 Monthly & Quarterly Disciplinary Actions*, FINRA, http://www.finra.org/Industry/Enforcement/DisciplinaryActions/MonthlyActions/2013/ (last visited Jan. 11, 2015).

The matters examined are those publicly disclosed by FINRA in its monthly enforcement reports in the period stated above. In some cases, there is a lag between FINRA resolving a matter against a broker-dealer and it reporting that matter in a monthly report. Accordingly, some matters reported in the early months of 2008 may have been resolved in late 2007, and some matters resolved late in the first half of 2013 may not have been reported by June 2013. The author is not aware of any matters against investment bankers resolved during the period under analysis other than those reported in the tables in this Part.

The monthly reports also include extensive summaries of high-profile matters resolved by FINRA, typically appearing at the end of the reports. Despite their prominence, identifying characteristics for these matters—such as FINRA case numbers and CRD numbers—were excluded from the monthly reports. These matters were identified using FINRA's BrokerCheck function and were examined in this study. *See supra* note 5.

Other matters excluded from analysis include complaints filed by FINRA and enforcement actions under appeal (both of which were summarized in monthly reports). These matters were not included in the study until they were resolved.

electronically for key terms related to investment banking.[216] Public financial media sources were also searched to identify any additional reported FINRA disciplinary matters. For each of the approximately 500 disciplinary matters identified, the underlying settlement agreements or adjudicative decisions were reviewed for relevance.

While many of the identified matters involved securities offerings, relatively few were relevant. Only those matters involving securities offerings in which an individual's conduct was "client-facing," rather than "investor-facing," were relevant.[217] Private placement offerings were treated slightly differently. In these transactions, involving the sale of unregistered securities exempt from registration under the Securities Act of 1933,[218] the same individuals generally perform both parts of the offering process. Matters involving these deals were reviewed to classify the conduct in question as either client-facing or investor-facing; only matters involving the former type were included.[219]

The monthly reports also listed firms expelled or "cancelled" for, among other similar reasons, failing to pay fines, as well as individuals similarly sanctioned for failing to pay fees or keep information current. These matters, which FINRA did not summarize, were also excluded from analysis.

216 To identify terms most likely to capture conduct related to investment banking, monthly enforcement reports and the underlying settlement agreements or adjudicatory decisions for an approximately one-year period were reviewed in full. Based on this review, the following terms were chosen: investment bank; investment banking; investment-banking; investment banker; merge; merger; acquisition; acquire; M&A; takeover; tender offer; asset sale; underwrite; underwriter; underwriting; underwriting compensation; qualified independent underwriter; restructure; restructuring; financial advisor; financial adviser; Chinese wall; information barrier; watch list; restricted list; grey list; confidential; confidential information; fiduciary; due diligence; advise; advised; NYSE; New York Stock Exchange; fairness opinion; solvency opinion; valuation; managing director; research report; research analyst; private placement; placement agent; solicit investment banking; soliciting investment banking; and PIPE.

217 As explained above, securities offerings divide naturally into two parts: a "client-facing" function involving investment banking services, and an "investor-facing" function involving marketing and sales of securities. *See supra* notes 64–67 and accompanying text.

218 Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74. Offers or sales of securities are exempt from registration with the SEC pursuant to Section 4(a)(2) of the Securities Act of 1933 or Regulation D under that Act, provided that they satisfy certain conditions, such as conditions related to the aggregate offering price, number of purchasers, or sophistication of purchasers. *See* 15 U.S.C. § 77d (2012). For a recent study of FINRA enforcement matters involving private placement transactions, see Johnson, *supra* note 23.

219 Conduct regarded as sales-related—and thus excluded from analysis—included misrepresentations made to investors; the performance of due diligence (where it was performed to aid an individual's understanding of the nature of the security she was selling or the security's potential suitability for investors); the sale of securities in violation of Section 5 of the Securities Act or of anti-money laundering provisions; trading activities by an underwriter in violation of Regulation M; or any conduct indicating that the broker-dealer was a member of the selling group,

2. *Results*

Table 1 summarizes FINRA disciplinary matters resolved with the imposition of a sanction against individuals.

TABLE 1. INDIVIDUALS SANCTIONED BY FINRA FROM JANUARY 2008 TO JUNE 2013[220]

	2008	2009	2010	2011	2012	2013	Total
All individuals sanctioned	633	687	746	776	892	382	4,116
Investment bankers sanctioned	4	1	4	3	6	0	18
Investment bankers sanctioned for misconduct toward investment banking client (other than misusing client information)	(0)	(0)	(0)	(1)	(4)	(0)	(5)
Investment bankers sanctioned for misusing investment banking client information	(2)	(1)	(1)	(1)	(0)	(0)	(5)
Investment bankers sanctioned for soliciting investment banking business in violation of research analyst rules	(0)	(0)	(0)	(0)	(2)	(0)	(2)
Investment bankers sanctioned for misconduct toward employer	(1)	(0)	(2)	(0)	(0)	(0)	(3)
Investment bankers sanctioned for improper registration	(1)	(0)	(1)	(1)	(0)	(0)	(3)

rather than the underwriting syndicate. As to the conceptual distinction between the underwriting syndicate and selling group, see COX ET AL., *supra* note 62, at 108–10.

For examples of disciplinary matters excluded on these bases, see, for example, Order Accepting Offer of Settlement, Fordham Fin. Mgmt., Inc., Disciplinary Proceeding No. 2008011743303 (Fin. Indus. Regulatory Auth. Mar. 25, 2013) (violation of Regulation M); Order Accepting Offer of Settlement, GBM Int'l, Inc., Disciplinary Proceeding No. 2010020846601 (Fin. Indus. Regulatory Auth. Dec. 10, 2012) (violation of Section 5); Letter of Acceptance, Waiver & Consent No. 2011025852101 from Thomas Baxter Cordingly to Dep't of Enforcement, Fin. Indus. Regulatory Auth. (Nov. 13, 2012) (the performance of due diligence).

On the same basis, a small number of matters involving FINRA sanctioning firms (under FINRA Rule 2711) for failing to disclose investment banking revenues in their research reports to investors were excluded. However, any matter in which a firm (or its research analysts) was sanctioned for engaging in investment banking conduct, such as soliciting investment banking business, was included in the data set.

Where the distinction was difficult to draw, a matter was regarded as "client-facing" and included in the data set.

220 Each of these individuals was a person associated with a member of FINRA. Because some matters had multiple respondents, the numbers listed above exceed the total number of FINRA disciplinary matters imposing sanctions against individuals.

As Table 1 shows, FINRA resolved disciplinary matters with the imposition of a sanction against 4,116 individuals during the period examined. Of these individuals, eighteen were investment bankers. Five misused an investment banking client's nonpublic information, five engaged in other misconduct toward their clients, two solicited investment banking business in violation of rules forbidding research analysts from engaging in such conduct, three committed misconduct toward their employers, and three violated rules regarding their registration with FINRA. Since the conduct in violation of research analyst rules was committed by research analysts, these two matters are not directly responsive. The conduct involving registration improprieties and misconduct toward employers was committed by investment bankers, but was not client-facing. Accordingly, ten of the eighteen investment bankers engaged in some form of misconduct toward clients.

TABLE 2. FIRMS SANCTIONED BY FINRA FROM JANUARY 2008 TO JUNE 2013[221]

	2008	2009	2010	2011	2012	2013	Total
All firms sanctioned	249	280	286	304	337	189	1,645
Firms sanctioned for the conduct of their investment bankers	3	2	0	6	3	2	16
Firms sanctioned for misconduct toward investment banking clients	(0)	(1)	(0)	(0)	(1)	(0)	(2)
Firms sanctioned for misconduct concerning information barriers	(3)	(0)	(0)	(3)	(2)	(1)	(9)
Firms sanctioned for improper registration of investment bankers	(0)	(1)	(0)	(2)	(0)	(1)	(4)
Firms sanctioned for soliciting investment banking business in violation of research analyst rules	(0)	(0)	(0)	(1)	(0)	(0)	(1)

Disciplinary matters resolved with the imposition of sanctions against firms for the conduct of investment bankers were also identified and coded. Table 2 reports the results.[222]

221 The information barriers at issue in the category for "misconduct concerning information barriers" were those intended to separate the firm's investment banking functions from other parts of the firm. *See supra* note 122.

222 In addition, FINRA sanctioned compliance professionals for investment banking misconduct. Specifically, FINRA sanctioned one compliance professional in each of 2009 and 2013 for failing to ensure the registration of investment bankers at the professional's firm. In

During the same period, FINRA resolved disciplinary matters with the imposition of a sanction against 1,645 firms, 16 of which were sanctioned for the misconduct of their investment bankers. Two such firms were sanctioned for misconduct toward clients—one for charging excessive underwriting compensation and the other for conflicts of interest in underwriting a securities offering.[223] Four of the sixteen firms faced sanctions for improperly registering investment bankers, and one for allowing its research analysts to solicit investment banking business. Nine of the sixteen firms faced sanctions for failing to enforce information barriers between their investment banking segments and other segments of the firm. In these matters, the firms were sanctioned for failing to establish, maintain, or enforce information barriers around their investment banking activities[224] rather than misusing nonpublic information in specific instances. Strictly speaking, therefore, these firms were not sanctioned for the misconduct of investment bankers because no underlying misconduct by investment bankers was involved. These matters are nevertheless included in Table 2 because they may be regarded as the institutional counterparts of matters involving individuals misusing nonpublic information. Leaving them aside, though, only seven firms were sanctioned for the misconduct of their investment bankers. The details of these matters are further considered below.

III. Deterrence Effect of Self-Regulation

The Article now assesses the effectiveness of FINRA's enforcement activity in deterring investment bankers' misconduct.

A. *Self-Regulation Alone*

1. *Theoretical Framework*

Optimal deterrence theory, as it has been developed in the economic analysis of legal rules, provides a useful theoretical framework

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addition, in 2012 FINRA sanctioned a compliance officer for failing to ensure the adequacy of his firm's information barriers related to its investment banking functions.

223 *See* Letter of Acceptance, Waiver & Consent No. 2009017346702 from CM Sec., LLC & Todd Parriott to Dep't of Enforcement, Fin. Indus. Regulatory Auth. (Nov. 18, 2012) (charging excessive underwriting compensation); Letter of Acceptance, Waiver & Consent No. 2007011942201 from Paramount BioCapital, Inc. to Dep't of Enforcement, Fin. Indus. Regulatory Auth. (Sept. 4, 2009) (conflicts of interest in underwriting).

224 As broker-dealers, financial conglomerates must "establish, maintain and enforce" Chinese walls. *See* 15 U.S.C. § 78o(g) (2012). For further self-regulatory guidance, see *supra* note 122.

for evaluating FINRA's enforcement activity.[225] Under the theory of optimal deterrence, individuals are optimally deterred when they internalize the social costs of their wrongdoing, leading them to take optimal precautions to prevent or limit those costs.[226] An optimal regulatory regime minimizes the social costs of wrongdoing. That is to say, it minimizes the sum of the expected cost of the wrongdoing, the cost of precautions taken to prevent or limit that wrongdoing, and the administrative cost associated with enforcing the regime.[227] Leaving aside the administrative cost, over which the wrongdoer has no control, such a regime leads wrongdoers to minimize the sum of the social costs they impose and the cost of the precautions they take to prevent or limit those social costs.

Because wrongdoers often escape sanction, optimal deterrence theory counsels that any sanction a wrongdoer faces should be set such that its *expected value* equals the social cost of the wrong.[228] The expected value of a sanction is the product of two variables—the magnitude of the sanction and the probability of the sanction being imposed.[229] With the sanction set at the expected value, the wrongdoer would expect to face the social costs of his wrong—and thus be led to act desirably by internalizing the social costs he imposes.[230]

Several implications follow from the theory. First, because both the magnitude of the sanction and the probability of the sanction be-

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225 As to optimal deterrence theory, see generally STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW (1987). *See also* GUIDO CALABRESI, THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS (1970); Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968).

226 *See* STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 473–514 (2004). The theory assumes rationality on the part of those regulated as well as an ability to pay any sanction imposed. Neither assumption seems troubling given the incentive-based world in which investment bankers operate and the financial rewards they enjoy.

227 *See* SHAVELL, *supra* note 225, at 1–3; *see also* CALABRESI, *supra* note 225, at 26.

228 *See* SHAVELL, *supra* note 226, at 482–83. This condition applies to the risk-neutral wrongdoer. But actors vary in their tolerance for risk and thus will not be equally deterred by different combinations of probability and magnitude of sanctions with the same expected value. *See id.* at 479. The risk-averse actor, one whose experience of disutility of sanctions increases out of proportion to their size, will be more deterred by a combination with a higher sanction than one with a lower sanction with the same expected value. The reverse is true of the risk-lover: holding the expected sanction constant, a risk-loving individual will be more deterred by a higher probability of sanction than a more severe sanction. *See id.*

229 *See id.* at 473 ("The principal problems for society that are studied are the choice of the level of enforcement effort—which determines the probability of penalizing parties—and the choice of the magnitude of sanctions, so as to maximize social welfare.").

230 For example, if a wrongdoer creates social costs of 10 and has a 50% chance of facing sanction, the sanction imposed should be 20. If he commits the wrong, he would then *expect* to face a sanction of 10 (0.5 x 20), inducing him to minimize the harm he creates.

ing imposed affect the expected value of the sanction, its deterrence force can be maintained with reductions in either variable. Of course, limits may exist on the extent to which the magnitude or probability of a sanction may be varied.[231] In some settings, underdeterrence will result.[232] Second, it also follows that perceptions about the probability of a sanction matter.[233] The banker who perceives the probability of sanction as high would be more deterred than one who perceives it as low, given the same magnitude of the sanction.[234] Because perceptions of the probability of sanction may promote deterrence, factors influencing these perceptions also matter.

The theory is difficult to operationalize because of the impossibility of knowing with certainty the precise quantity of many variables.[235] Determining the probability of sanction requires knowledge of overall wrongdoing—an elusive parameter.[236] While monetary sanctions may be reliably quantified, other sanctions—such as loss of licenses—must be estimated.[237] Determining the social costs created by wrongdoing requires somewhat crude estimation. Optimal deterrence theory nevertheless provides a powerful analytical framework[238] and, accordingly, this Article grapples with the task of assessing the effectiveness of FINRA's enforcement activity in deterring investment bankers' misconduct. The task is obviously greatly simplified by the dearth of enforcement activity.

The focus of inquiry, as stated, is the FINRA regime's effect on investment bankers measured against the benchmark of optimal deterrence—namely, the level of deterrence that will ideally control behavior by inducing bankers to internalize the social costs of their wrongs. The distinct question of whether FINRA's enforcement is optimal (for FINRA) considering its resources and competing priorities is also confronted, but this is not the central inquiry.

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231 The magnitude of sanction will be limited by the wealth of wrongdoers and perhaps also by expectations that sanctions be "proportional" to the underlying wrongs. *See id.* at 482–84.

232 *See id.* at 488.

233 *See id.* at 481–82.

234 As to the effect of perceptions of the probability of sanctions on a regulatory regime's deterrence, see *id.* at 481. Perceptions of the magnitude of sanctions also matter, although they are likely to more closely comport with reality than are perceptions of the probability of sanctions, because the magnitudes of sanctions are often stipulated and well known in advance. *Id.*

235 *See* Jackson, *supra* note 211, at 257–64 (in the context of cross-country studies of enforcement intensity, discussing the difficulties of operationalizing theoretical insights, but proceeding nevertheless to use empirical assessments and proxies to draw broad conclusions).

236 *See id.* at 258–61.

237 *See id.* at 262.

238 *See id.* at 257.

2. *Application of the Framework*

At first glance, the intensity of FINRA's enforcement against investment bankers and their firms during the relevant period appears strikingly weak. FINRA sanctioned only eighteen individuals and seven firms for any form of misconduct by investment bankers.[239] No investment banker was sanctioned for conduct in advising on a public M&A deal or a registered securities offering—the most important transactions on which investment bankers advise. Similarly, no firm was sanctioned for the conduct of its investment bankers toward a client in a public M&A transaction or toward an (issuer) client in a registered securities offering. These figures stand in stark contrast to FINRA's overall enforcement activity for the same period, during which it sanctioned 4,116 individuals and 1,645 firms.

Operationalizing the framework to assess FINRA's deterrence force requires several steps of analysis. First, to ascertain the probability of sanction by FINRA we must consider both the virtual absence of enforcement activity against investment bankers, or firms for the conduct of investment bankers, and the apparent pervasiveness of investment bankers' misconduct.[240] Although it is impossible to know with certainty all the misconduct committed by investment bankers, the evidence strongly suggests that FINRA enforcement activity against investment bankers and firms for the conduct of investment bankers reflects but a small proportion—and possibly even an infinitesimally small proportion—of investment bankers' misconduct, giving rise to a similarly low probability of sanction.[241]

Second, not only is the probability of sanction apparently low, but it is implausible that investment bankers could have perceived otherwise. It is likely that investment bankers perceived little threat of FINRA enforcement, if they perceived any at all.[242] FINRA could have undertaken efforts to create a perception of heightened enforce-

239 *See supra* Table 2.

240 *See supra* Part I.B.4.

241 FINRA, at a minimum, overlooked the misconduct highlighted by the Delaware Court of Chancery. *See supra* notes 174–91 and accompanying text.

242 As some indication, consider the following exchange in Senate hearings regarding the controversial ABACUS 2007-AC1 transaction in which the investment banker seemed unaware of FINRA's regulatory role:

> Senator Pryor. . . . [L]awyers have to follow certain ethical standards. A doctor has to follow certain ethics standards. CPAs follow ethical standards, and, most professions have some sort of manual or some sort of code of ethics that they follow. Are you saying that is not the case in all aspects of your industry?
>
> Mr. Sparks. No, Senator. I know where I worked, ethical standards were very important.

ment through enforcement activity against high-profile investment bankers, or against investment bankers working on landmark transactions.[243] However, only three of the disciplinary matters against investment bankers or against firms for the conduct of investment bankers involved high-profile investment bankers or firms. One involved a former JP Morgan investment banker being fined $10,000 and suspended for sixty days for failing to disclose to her employer her private securities trading accounts.[244] She had traded in the stock of at least one of her clients, but she was not accused by FINRA of misusing nonpublic client information.[245] The FINRA matter arose several years after the conduct, and after the banker had left the firm. Another matter concerned an employee of Deutsche Bank who had misappropriated his employer's property when he left the firm.[246] The other matter involved FINRA fining JP Morgan $125,000 for permitting three (unidentified) managing directors in its investment banking division to perform investment banking functions while unregistered.[247] FINRA took no action against the investment bankers indi-

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> Senator Pryor. Were those done by the company, or were they done by the industry, or were they done by the government?
>
> Mr. Sparks. At Goldman, ethical standards were a focus. Numerous times there would be various off-site—when I say off-site, I mean you would take people out of what they were currently doing to go and discuss ethics and how important it is and how you deal with complex issues.
>
> Senator Pryor. Were those Goldman standards, or were they some sort of national standard or some industry standard? When you talk about ethics, what are you talking about?
>
> Mr. Sparks. Those were Goldman standards, but I would tell you that industry—they factored in industry standards, and I would say, I guess, national standards. But I think Goldman Sachs had its own view of what those standards should be . . . .

Wall Street and the Financial Crisis: The Role of Investment Banks: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Gov't Affairs, 111th Cong. 54 (2010) [hereinafter *Wall Street and the Financial Crisis*] (exchange between Sen. Mark Pryor and Daniel Sparks, former Head of the Mortgage Department, Goldman Sachs).

243 Although, to the author's knowledge, no firm theoretical or empirical foundation exists for the claim that these factors influence perceptions, the possibility that they do is plausible.

244 *See* Letter of Acceptance, Waiver & Consent No. 2007009466801 from Susana Maria de la Puente to Dep't of Enforcement, Fin. Indus. Regulatory Auth. (June 4, 2008).

245 *See id.*

246 *See* Letter of Acceptance, Waiver & Consent No. 2007009423401 from Topang Kong to Dep't of Enforcement, Fin. Indus. Regulatory Auth. (July 15, 2008) (respondent, a former employee of Deutsche Bank, copied proprietary models and deal documents prior to leaving his employer to take up a position at a competing firm).

247 Letter of Acceptance, Waiver & Consent No. 2011027800601 from J.P. Morgan Sec. LLC to Dep't of Enforcement, Fin. Indus. Regulatory Auth. (Mar. 4, 2013). JP Morgan was found to have violated both NASD Rule 1032(i)(1) and FINRA Rule 2010. *See id.* In addition, JP Morgan failed to enforce its written supervisory procedures requiring registration by the

vidually, identifying them simply as "MD1," "MD2," and "MD3."[248] None of these potentially high-profile matters appears to have attracted financial media attention.[249]

Apart from matters of insider trading or related market abuse, the matters FINRA resolved are likely of little interest to investment bankers. The matters against investment bankers, or firms for the conduct of investment bankers, are an odd assortment and suggest no particular enforcement priorities. For example, one investment banker was sanctioned for violating his employer's internal policies while "attempting to procure investment banking and consulting business from . . . a publicly-traded company."[250] He had used his personal e-mail account, rather than his firm account, to communicate with the potential client and had posted messages about the client on a Yahoo! message board, including "[t]his one looks like a gem" and "[s]till digging into this one but looks like the real deal."[251]

FINRA sanctioned another investment banker for embellishing his experience by falsely telling a prospective client he had advised on a reverse takeover and for misleading another potential client about the work he was doing for it.[252] Not persuaded, the clients went elsewhere—but the banker suffered FINRA discipline.[253] One investment banker incurred FINRA's wrath for charging excessive underwriting compensation,[254] and FINRA pursued another banker for allegedly misusing a client's deposit and lying to the client about its return.[255] One would not expect these matters to attract industry attention.

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three bankers, despite knowing when they joined the firm that they were unregistered, in violation of both NASD Rule 3010 and FINRA Rule 2010. *See id.*

248 *See id.*

249 Rather, of the disciplinary matters reported in Tables 1 and 2, only one was reported in either *The Wall Street Journal* or *Financial Times.* That matter involved FINRA sanctioning Rodman & Renshaw, in part, for the conduct of an investment banker involved in determining compensation of research analysts. *See* Alexandra Scaggs, *Finra Fines Firm, Alleges Research Violations*, WALL ST. J., Aug. 23, 2012, at C2; Letter of Acceptance, Waiver & Consent No. 20110260605 from Rodman & Renshaw, LLC and William A. Iommi to Dep't of Enforcement, Fin. Indus. Regulatory Auth. (July 16, 2012).

250 Letter of Acceptance, Waiver & Consent No. 2011030840501 from Christopher A. Carra to Dep't of Enforcement, Fin. Indus. Regulatory Auth. (June 25, 2012).

251 *Id.*

252 Letter of Acceptance, Waiver & Consent No. 20100211160-01 from Richard S. From to Dep't of Enforcement, Fin. Indus. Regulatory Auth. (Aug. 27, 2011).

253 He was fined $5,000 and suspended from associating with any FINRA member for thirty days. *See id.*

254 Letter of Acceptance, Waiver & Consent No. 2009017346702, *supra* note 223.

255 Blair Alexander West, Compl. No. 2009018076101, 2014 WL 670152, at *3 (Fin. Indus. Regulatory Auth. Feb. 20, 2014) (decision).

The third analytical step in assessing FINRA's deterrence force focuses on the magnitude of sanctions imposed by FINRA. Severe sanctions may offset the effect of a low probability of sanction, and thus achieve optimal deterrence. But the sanctions FINRA imposed in the matters were modest and generally in proportion to the wrongdoing, and thus unlikely to have achieved optimal deterrence given the low probability of sanction.[256]

FINRA lacks the power to imprison individuals, although it may ban them from the industry.[257] In the disciplinary matters discussed above against individuals and firms,[258] FINRA fined bankers between $5,000 and $20,000 (and $250,000 in one matter that also involved conduct unrelated to investment banking).[259] In matters involving insider trading it fined firms larger amounts,[260] but these amounts were roughly proportional to the wrongdoing, rather than magnified to offset the diminution of deterrence resulting from the low probability of sanction.

Finally, one must compare the costs of increased deterrence with the benefits of increased deterrence. One could not fault FINRA for failing to further deter misconduct if the costs of doing so would exceed any benefits. Such costs comprise the direct costs of detecting wrongdoing as well as indirect costs, including the potential chilling

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256 *See supra* notes 225–34 and accompanying text.

257 *See* 15 U.S.C. § 78o-3(b)(7) (2012) (permitting self-regulating organizations, such as FINRA, to ban individuals). Surprisingly, FINRA may not enforce the payment of fines it levies. *See* Fiero v. Fin. Indus. Regulatory Auth., Inc., 660 F.3d 569, 571 (2d Cir. 2011); *see also* Jonathan Macey & Carolin Novogrod, *Enforcing Self-Regulatory Organization's Penalties and the Nature of Self-Regulation*, 40 Hofstra L. Rev. 963, 1001–03 (2012) (arguing for increased detection of wrongdoing by FINRA because of their limitations on imposing sanctions).

258 *See supra* notes 244–55 and accompanying text.

259 For misrepresentations to clients, one banker was suspended for thirty days and fined $5,000. *See* Letter of Acceptance, Waiver & Consent No. 20100211160-01, *supra* note 252. Another was suspended for one year and fined $20,000. *See* Letter of Acceptance, Waiver & Consent No. 2011030840501, *supra* note 250. A third banker was suspended for one year and ordered to pay restitution of $250,000, although his misconduct towards his client was just one violation among many others unrelated to investment banking. *See See* Letter of Acceptance, Waiver & Consent No. 2009017346702, *supra* note 223. Another who failed to disclose to her employer her private trading accounts, but who was not accused of misusing nonpublic client information, was suspended for fifty days and fined $10,000. *See* Letter of Acceptance, Waiver & Consent No. 20070094668, *supra* note 244. In contrast, all bankers who misused nonpublic client information faced industry bans. These sanctions seem proportional to the wrongdoing, and would seem unlikely to compensate for a low probability of sanction.

260 *See, e.g.*, Joseph A. Geraci, II, Compl. No. CMS020143, 2004 WL 2891525, at *17 (Nat'l Ass'n of Sec. Dealers Dec. 9, 2004) (decision) (barring an individual from associating with any NASD member following insider trading).

effect of increased deterrence.[261] Because some misconduct may have been sanctioned with little outlay in direct costs (namely, the wrong-doing identified by the Delaware Court of Chancery[262]) and yet have had a powerful deterrence effect, the benefits of further deterrence likely outweighed the costs.

In sum, therefore, the evidence suggests that FINRA underdeterred investment bankers' misconduct. The probability of sanctions was low and perhaps even negligible. Nothing about the nature of the matters brought would seem to have led bankers to perceive the threat of sanction as greater than the reality. The magnitude of sanctions could not realistically have compensated for the low probability of sanction so as to achieve optimal deterrence. Nothing seems to suggest the costs of increased deterrence of bankers' misconduct were greater than the expected benefits. While the effect of the other disciplinary forces must also be examined, and they are below, the evidence strongly suggests that FINRA regulation failed to optimally deter investment bankers' misconduct and, moreover, failed to credibly deter such misconduct at all.

The evidence further suggests that FINRA's regulation of investment bankers, as currently administered, may not be worth the costs it imposes on the financial industry. The existing system of self-regulation burdens investment bankers and their employers by imposing extensive qualifications and registration requirements (compliance with which is publicly observable and apparently high).[263] It imposes other constraints on firms relating to their financial condition and operations and record-keeping.[264] Although the qualifications and registration regime may screen some undesirable individuals, the benefits flowing from FINRA's deterrence nevertheless seem slight.[265] Given the burdens and the limited deterrence benefits, it is clearly reasona-

261 For a general discussion of the relationship between deterrence and chilling effects, see generally Louis Kaplow, *Multistage Adjudication*, 126 HARV. L. REV. 1179, 1189 (2013) ("[A] chilling effect[ ] is the counterpoint to deterrence: for cases in which [individuals] . . . engaged in benign acts . . . [those individuals face] costs and some chance of being found liable.").

262 *See supra* notes 174–91 and accompanying text.

263 The claim here is not that investment bankers comply with FINRA rules generally, but that they qualify and register as required by certain FINRA rules. *See supra* Part I.

264 *See, e.g.*, FINRA MANUAL R. 4110 (2010), R. 4160 (2011), R. 4510–4570 (2011) (imposing requirements for net capital, verification of assets, books, and recordkeeping).

265 Deterrence may flow from sources other than the enforcement of rules. For instance, regulators may engage in "persuasion" and more intensive supervisory engagements with regulatees. *See* IAIN G. MACNEIL, AN INTRODUCTION TO THE LAW ON FINANCIAL INVESTMENT 111–12 (2d ed. 2012). These other approaches seem more commonly adopted in other jurisdictions, such as the United Kingdom, and are not obvious features of FINRA regulation.

ble to believe that the costs of FINRA's existing regulation of investment bankers, as now administered, exceed the benefits.

Before assessing additional deterrence mechanisms, consider the distinct question whether FINRA's enforcement is optimal for FINRA, taking into account its resources and the need to regulate other broker-dealers. The data in Tables 1 and 2 show that FINRA devotes the vast bulk of its enforcement resources to disciplining individuals other than investment bankers. Because FINRA does not disclose the proportion of investment bankers among the 630,000 associated persons it regulates,[266] and such data is not available from alternative public sources, one cannot reliably infer whether investment bankers are significantly more or less likely to face sanction than other associated persons. Similarly, it is difficult to infer whether broker-dealer firms are significantly more or less likely to face sanction for investment bankers' misconduct than for the misconduct of other associated persons. The data do not allow any inferences as to the relative culpability of investment bankers and other associated persons. We cannot, therefore, infer whether FINRA optimally (from FINRA's perspective) allocates its enforcement resources between investment bankers and other types of broker-dealers.

Nevertheless, the potential constraints imposed by FINRA's resources should not be overstated. FINRA holds a substantial investment portfolio of cash, securities, and real property, most recently valued at approximately $2 billion.[267] FINRA established the portfolio to provide "supplemental financial resources" to support its enforcement mission,[268] and treats it much like colleges treat their endowments—preserving the principal and spending the returns. FINRA also imposes fees on its members and associated persons, outside the constraints of the normal congressional budget process.[269]

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266 As of December 31, 2012, FINRA oversaw "almost 630,000 registered securities representatives." *See* FINRA 2012 REPORT, *supra* note 13, at 8. In this context, the term "securities representatives" is synonymous with "associated persons."

267 *See* FIN. INDUS. REGULATORY AUTH., FINRA 2013 YEAR IN REVIEW AND ANNUAL FINANCIAL REPORT 10 (2014) [hereinafter FINRA 2013 REPORT], *available at* https://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p534386.pdf (stating the value of FINRA's investments as of December 31, 2013).

268 *See id.*

269 FINRA may therefore increase fees to expand its operating budget, as it did in 2012. *See* Dan Jamieson, *FINRA Turns a Profit, Helped by Investments, Fee Increases*, INVESTMENTNEWS (June 28, 2013, 5:14 PM), http://www.investmentnews.com/article/20130628/FREE/130629921/finra-turns-a-profit-helped-by-investments-fee-increases (registration required) (reporting on FINRA fee increases for its members).

Its net revenues in 2013 were $900 million,[270] a sum sufficient to pay its chief executive officer $2.5 million and seven other key employees approximately $1 million each.[271] It is therefore questionable whether FINRA's resources imposed a hard constraint on its enforcement activities.

B. *Explanatory Factors*

Several factors may help to explain FINRA's weak deterrence of investment bankers' misconduct.

1. *Investigative Approach*

FINRA's weak enforcement record is partially explained by inadequate incentives for clients to complain to FINRA about investment bankers, as well as FINRA's investigative approach.[272] If FINRA disciplines broker-dealers based primarily on complaints made by aggrieved investors or clients, rather than on the fruits of independent fieldwork, one would expect low enforcement activity consistent with the evidence presented in Part II.B. Because FINRA rarely orders broker-dealers to compensate complainants, an outcome about which it informs complainants in advance,[273] the primary incentive to complain—and thus invoke FINRA's enforcement apparatus—would stem from a sense of injustice.[274] Yet, these motivations are far more commonly associated with individual customers than investment bankers' clients, which are typically large corporations. The senior managers of such corporations would bear only a fraction of any losses suffered by their corporations from investment banking miscon-

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270 FINRA 2013 Report, *supra* note 267, at 9.

271 *Id.* at 24; *see also* Steven Irwin et al., *Self-Regulation of the American Retail Securities Markets—An Oxymoron for What Is Best for Investors?*, 14 U. Pa. J. Bus. L. 1055, 1073 (2012) (describing FINRA's funding sources).

272 My thanks to Gerrit De Geest for suggesting this explanatory factor.

273 In its Investor Complaint Program brochure, FINRA makes clear the limits of its disciplinary powers. It cautions potential complainants that "the focus of a FINRA investigation is regulatory in nature, and . . . you are encouraged to consider other means if you are seeking to recover money or securities," and further that "[t]here can be no assurances that any action taken by FINRA will result in a payment or return of funds or securities to you even where formal disciplinary matters are taken and sanctions imposed." Fin. Indus. Regulatory Auth., Investor Complaint Program: What to Do When Problems Arise 9 (2014), *available at* http://www.finra.org/web/groups/investors/@inv/@protect/@after/documents/investors/p011944.pdf. Instead, FINRA informs clients that they may resolve disputes with broker-dealers through litigation, arbitration, or mediation. *See id.* at 10.

274 For a discussion of how the inability of a public regulator to award damages to defrauded consumers provides consumers with inadequate incentives to report fraud to the public regulator, see Richard A. Posner, Economic Analysis of Law 391–93 (7th ed. 2007).

duct (to the extent of their shareholding in the corporation and any reputational fallout), whereas individuals would typically bear any loss in full. The clients of investment bankers—i.e., corporations—thus have weaker incentives to complain to FINRA than do the clients of other broker-dealers.

Although FINRA does not fully disclose its investigative approach, it would seem likely that it initiates many disciplinary matters based on client complaints, rather than by using other methods of factfinding such as independent fieldwork.[275] FINRA cannot compel cooperation from parties other than its members and their associated persons and other employees.[276] For example, FINRA cannot compel an investment banker's client (or its senior managers) to cooperate in an investigation, such as by producing documents or providing testimony.[277] Accordingly, FINRA's efforts are stymied when disciplinary action depends on the cooperation of such parties (who may have no incentive to cooperate),[278] which potentially discourages FINRA from independently initiating proceedings in the first place.

FINRA periodically conducts targeted examinations or "sweeps" of broker-dealers, but to date none have focused specifically on firms' investment banking functions.[279] FINRA publishes a letter annually of its regulatory and examination priorities.[280] Apart from expressing

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275 FINRA also initiates some matters based on member firms reporting their decisions to terminate the employment of certain employees. *See* FIN. INDUS. REGULATORY AUTH., REGULATORY NOTICE 11-32: REPORTING REQUIREMENTS—FINRA PROVIDES ADDITIONAL GUIDANCE REGARDING REPORTING REQUIREMENTS UNDER RULE 4530, at 7 (2011), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p123929.pdf. Additionally, Rule 4530 requires its members to self-report any member's or associated member's FINRA rule violations. FINRA MANUAL R. 4530 (2013).

276 *See* FIN. INDUS. REGULATORY AUTH., *supra* note 273, at 7 ("Conduct Rules require brokerage firms, their brokers and employees to cooperate fully with these investigations. FINRA, however, does not have general subpoena power and cannot compel cooperation of non-industry personnel, such as issuers of securities or their executives."); *see also* NAT'L ASS'N OF SEC. DEALERS, NOTICE TO MEMBERS 04-44, at 558 (2004), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p003012.pdf.

277 *See id.*

278 In its Complaint Program brochure, FINRA warns that "[w]ithout your cooperation, we may be unable to take disciplinary action against a brokerage firm or its employees." FIN. INDUS. REGULATORY AUTH., *supra* note 273, at 7.

279 For a list of topics on which FINRA has conducted targeted examinations since 2007, see *Targeted Examination Letters*, FINRA, http://www.finra.org/Industry/Regulation/Guidance/TargetedExaminationLetters/ (last visited Jan. 11, 2015). Two such examinations have focused on firms' handlings of conflicts of interest and the use of information barriers. *See id.* These would necessarily involve firms' investment banking activities.

280 *See, e.g.*, FIN. INDUS. REGULATORY AUTH., 2013 REGULATORY AND EXAMINATION PRIORITIES LETTER (2013), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p197649.pdf.

concern in 2013 about the risk of insider trading, none of these letters targeted firms' investment banking functions.[281]

The customer-complaints explanation seems plausible in light of disciplinary matters that would otherwise be difficult to explain. For instance, in 2011, FINRA sanctioned an investment banker for overstating his experience (claiming, falsely, to have advised on a reverse merger) and for exaggerating the work he had performed for a potential client.[282] Though dishonest and deserving sanction, such conduct would seem par for the course in the fiercely competitive investment banking industry. When "pitching" for work, investment bankers are suspected of exaggerating their credentials and even actively misleading potential clients by, for example, claiming to have advised on relevant transactions in which their role was actually fairly limited.[283] In acting for targets in M&A transactions, investment bankers are regarded by some as having a known tendency to "at least exaggerate, if not actively mislead or lie," to achieve a high value sale.[284] Why this particular individual, a low visibility banker, would have been singled out is unclear, unless the prospective client brought the matter to FINRA's attention, prompting the disciplinary action.[285]

2. *Lack of Institutional Expertise and Generality of Rules*

The lack of investment banking expertise of FINRA's regulatory personnel, combined with the generality of FINRA's rules applicable to investment bankers, helps explain FINRA's weak enforcement record. The rarefied world of investment banking, in which high-stakes deals are conceived and executed by those in the highest echelons of business,[286] is far removed from the boiler rooms and high-pressure sales tactics with which FINRA personnel more regularly deal. FINRA personnel are far more likely to have direct personal experi-

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281 *See id.* at 5. For other letters, see *FINRA Annual Regulatory and Examination Priorities Letter*, FINRA, http://www.finra.org/Industry/Regulation/Guidance/CommunicationstoFirms/P122861 (last visited Jan. 11, 2015).

282 *See* Letter of Acceptance, Waiver & Consent No. 20100211160-01, *supra* note 252.

283 *See* REYNOLDS & NEWELL, *supra* note 4, at 111 ("[A]n investment bank may claim to have advised on another relevant transaction, but their advice may in reality have been very limited in scope. Inevitably, some elements of pitching are prone to exaggeration, but in some cases investment banks go further and pitches can contain actively misleading information.").

284 *Id.*

285 In sanctioning this low-level investment banker, FINRA relied exclusively on the "just and equitable" rule, the most versatile rule in its regulatory arsenal. Letter of Acceptance, Waiver & Consent No. 20100211160-01, *supra* note 252.

286 As to the rarified atmosphere in investment banking, see JENSEN, *supra* note 24, at 1–23. *See also infra* notes 299–303 and accompanying text.

ence with broker-dealers' sales and trading activities than with investment banking activities.[287] Although the required familiarity and expertise can clearly be acquired by those without personal investment banking experience—as evidenced by the Delaware judiciary[288]—little suggests that FINRA enforcement personnel are well acquainted with their members' "client-facing" investment banking activities.[289]

This lack of investment banking familiarity and expertise is particularly problematic given the generality of FINRA's rules. Although many specific rules do apply to investment bankers,[290] the "just and equitable" rule is broad, requiring simply that broker-dealers "observe high standards of commercial honor and just and equitable principles of trade."[291] FINRA frequently uses this rule as the sole basis for sanctioning broker-dealers who engage in conduct falling outside the reach of more specific rules.[292] Though broad enough to allow

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287 This claim is based on the observation that investment banking activities typically occur only at the institutional, or wholesale, level, while brokerage services are provided to individual, or retail, investors. *See* GEISST, *supra* note 61, at 1; *see also* Jennifer M. Pacella, *If the Shoe of the SEC Doesn't Fit: Self-Regulatory Organizations and Absolute Immunity*, 58 WAYNE L. REV. 201, 224 (2012) ("[M]ost [FINRA] regulatory cases have been brought against individual brokers.").

288 *See supra* notes 174–91 and accompanying text.

289 This explanation stands in tension with the oft-repeated claim that self-regulators have greater access to industry expertise than government regulators. *See supra* notes 57–59 and accompanying text. That claim, however, is a relative one; FINRA may well enjoy greater industry expertise than the SEC. It seems nevertheless not to enjoy that advantage in investment banking, perhaps due to the enormous pay differential between regulators and bankers and the noncommodifiable nature of investment banking services.

290 *See supra* notes 111–22 and accompanying text. Additionally, FINRA recently proposed a set of rules for so-called limited corporate financing brokers, a category of brokers that includes investment bankers. *See infra* note 376 and accompanying text.

291 FINRA MANUAL R. 2010 (2008).

292 Examples of conduct that violated Rule 2010 (and no other rule) include overstating one's credentials and exaggerating work performed for potential clients. *See* Letter of Acceptance, Waiver & Consent No. 20100211160-01, *supra* note 252. For examples of improperly sharing confidential customer information with an unaffiliated third person, see Steven Robert Tomlinson, Disciplinary Proceeding No. 2009017527501, 2013 WL 2146659, at *2 (Fin. Indus. Regulatory Auth. Mar. 21, 2013) (hearing panel decision); Letter of Acceptance, Waiver & Consent No. 2010024989201 from Carlos A. Dawkins to Dep't of Enforcement, Fin. Indus. Regulatory Auth. (June 22, 2012). For an example of commingling personal funds with investor funds, see Letter of Acceptance, Waiver & Consent No. 2011030168001 from Robert K. Brooks to Dep't of Enforcement, Fin. Indus. Regulatory Auth. (Jan. 15, 2013). For an example of making negligent misstatements and omissions in selling securities, see Letter of Acceptance, Waiver & Consent No. 2011026346205 from William Howard Coons to Dep't of Enforcement, Fin. Indus. Regulatory Auth. (Dec. 21, 2012). For an example of violating firm confidentiality policies, see Order Accepting Offer of Settlement, Anne Cameron, Disciplinary Proceeding No. 2010023578401 (Fin. Indus. Regulatory Auth. July 12, 2012). For an example of advising customers to register a complaint against a broker-dealer based on inaccurate information, see Letter of

FINRA to sanction investment bankers' misconduct and "enforce compliance with ethical standards beyond those required by law,"[293] the "just and equitable" rule nevertheless provides FINRA personnel with no guidance as to what constitutes "high standards."[294] Most of the legal doctrinal development regarding FINRA's rules has focused on retail broker-dealers performing traditional broker-dealer functions.[295] To be effective, principles-based rules, such as the "just and equitable" rule, require regulators to exercise sophisticated judgment.[296] If FINRA personnel lack an understanding of investment banking practices, the norms of conduct, and client expectations, they may be reluctant to determine appropriate standards of investment banking conduct and thus exercise greater caution in applying the rules.[297]

3. *Investment Bankers as the "Untouchables"*

A more troubling explanation for FINRA's weak deterrence of investment bankers' misconduct is that investment bankers are something of a protected class of broker-dealers—the "untouchables" of broker-dealer regulation. Investment bankers are the "elite of Wall Street."[298] In business literature, investment banking is regarded as a

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Acceptance, Waiver & Consent No. 2009017685301 from Michelle Y. Mangum to Dep't of Enforcement, Fin. Indus. Regulatory Auth. (July 25, 2011). For an example of participating in securities offerings while suspended from doing so, see Inv. Mgmt. Corp., No. 2005000960301 (Fin. Indus. Regulatory Auth. Jan. 14, 2008) (settlement). For an example of misrepresenting the historical delinquency rates for subprime residential mortgage-backed securities, see Letter of Acceptance, Waiver & Consent No. 2008012808801 from Barclays Capital Inc. to Dep't of Enforcement, Fin. Indus. Regulatory Auth. (Nov. 8, 2011).

293 *See* SEC. & EXCH. COMM'N, REPORT PURSUANT TO SECTION 21(A) OF THE SECURITIES EXCHANGE ACT OF 1934 REGARDING THE NASD AND THE NASDAQ MARKET 7 (1996); Birdthistle & Henderson, *supra* note 39, at 62 (describing Rule 2010 as "operat[ing] to capture conduct that cannot be efficiently or easily proved to violate another rule but that FINRA believes is worthy of sanction").

294 *See* FINRA MANUAL R. 2010 (2008).

295 *See supra* note 123 and accompanying text.

296 *See* Donald C. Langevoort, *Global Securities Regulation After the Financial Crisis*, 13 J. INT'L ECON. L. 799, 813 (2010) (identifying two conditions required "for principles-based regulation to work," one of which is "sophisticated judgment" by regulators).

297 Relatedly, FINRA personnel may exercise greater caution in applying principles-based regulation than other regulation if they perceive a greater risk of an adverse result. *See* John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 750 (2009) (suggesting that fear of reversal may lead "prosecutors . . . [to] enforce the principles-based prohibition only in more egregious cases").

298 *See* JENSEN, *supra* note 24, at 1 (referring to investment bankers as "the elite of Wall Street").

"white-shoe" role, while trading is considered to be "dirty work."[299] Investment bankers are idealized as patrician, urbane, well educated and even aristocratic.[300] Traders, by contrast, are "earthier"[301] and sometimes "sneered at" by investment bankers for their lowly position.[302] The most promising business school graduates are expected to go into investment banking, not trading.[303] Investment bankers are also regarded as enjoying a higher status than financial advisors, a type of broker-dealer that typically interacts with retail clients.[304]

Relatedly, FINRA's weak deterrence may reflect a perception of investment bankers as less likely to commit wrongdoing, or, when they do, as less culpable than other broker-dealers. Parallels may be drawn with white-collar crime. It is said that white-collar crime was largely overlooked and treated as less serious than "street" or "common" crime, in part because of assumptions that "the holders of privilege and power were basically honest."[305] Criminologists traced crime

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299 *See id.* ("From these origins, investment banking developed something of a 'white shoe' image. The dirty work of selling was left to someone else.").

300 For instance, the investment banker J. Tomilson Hill III of First Boston was described as "urbane, polished, well-educated." *See* JAMES B. STEWART, DEN OF THIEVES 63 (1991); *see also* RON CHERNOW, THE HOUSE OF MORGAN: AN AMERICAN BANKING DYNASTY AND THE RISE OF MODERN FINANCE xiii (1990) ("As practitioners of high finance, [investment bankers] cultivate a discreet style."); ECCLES & CRANE, *supra* note 149, at 68–69 ("Investment bankers are artists at managing image and presentation of self by wearing expensive clothes and the ubiquitous suspenders, traveling first class, demanding access to the CEO, simultaneously conveying an impression of aggressive self-confidence and obsequious servitude, and demanding an explanation from a customer for why another firm got the deal."); JENSEN, *supra* note 24, at 1–2 ("They are the elite of Wall Street. Their offices are furnished with expensive antiques and original works of art. They dress in conservatively cut $500 suits, and are as quick to place a telephone call to Rome or Zurich or Frankfurt as most Americans are to call their next-door neighbor . . . . They engineer multi-million-dollar transactions and, although they render middleman services only, enough money remains in their hands to make them the richest wage earners in the world. They are the investment bankers of Wall Street . . . .").

301 *See* STEWART, *supra* note 300, at 121 (referring to the battle between "the earthier traders" and "the more patrician investment bankers").

302 *See* KEN AULETTA, GREED AND GLORY ON WALL STREET: THE FALL OF THE HOUSE OF LEHMAN 3 (1986) (referring to Lewis L. Glucksman as being "disparaged by Wall Street bluebloods as a lowly 'trader'"); *id.* at 74 (stating that investment bankers at Morgan Stanley "sneered" at traders).

303 *See* STEWART, *supra* note 300, at 44–45 ("[Michael] Milken was unfazed by the tradition that held that promising business graduates went into investment banking—corporate finance, not sales and trading.").

304 For a description of the various types of broker-dealers, see *supra* note 22. Morgan Stanley bankers are said to have "traditionally regarded retail brokerage as beneath them, at least when compared with the rarefied world of advising corporate clients on going public or on mergers and acquisitions." Schwartz, *supra* note 22.

305 JAMES WILLIAM COLEMAN, THE CRIMINAL ELITE: UNDERSTANDING WHITE-COLLAR CRIME 1 (4th ed. 1998).

to poverty and related social conditions, including lack of education, and thus linked crime to lower socioeconomic status.[306] People are said to have been persuaded by arguments that individuals with enough political power to avoid government prosecution could not be criminals.[307] The notion of street crime as more harmful than white-collar crime is also regarded as "deeply rooted" in Anglo-American legal culture.[308] FINRA's weak enforcement activity against investment bankers may reflect its sluggishness—for any variety of similar reasons—in recognizing the merits of sanctioning misconduct by the broker-dealer elite.

Although somewhat speculative, this explanation garners support from FINRA's enforcement activities. The matter, described above, against JP Morgan for the registration failures of three of its managing directors is noteworthy for FINRA's decision to protect the identities of those bankers, describing them simply as "MD1," "MD2," and "MD3."[309] The mere fact that FINRA would protect the individuals from scrutiny is troubling, because FINRA places the obligation to register on the individuals themselves (as associated persons) rather than their firm.[310] It is also troubling that these individuals may have been high profile given their positions as managing directors. Even if FINRA had reasons to protect the identities of these individuals, one would expect those reasons to have been trumped by the terms of the rule, the objective of deterring similar misconduct by others (and potentially shifting bankers' perceptions as to the probability of sanctions), and the imperative of avoiding later doubt—that now exists—

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306 *See* Edwin H. Sutherland, White Collar Crime: The Uncut Version (1983), *reprinted in* Corporate and Governmental Deviance: Problems of Organizational Behavior in Contemporary Society 51, 52–54 (M. David Ermann & Richard J. Lundman eds., 1992).

307 *See* Coleman, *supra* note 305, at 2 ("By today's standards, it seems rather odd to argue that people who have enough political power to prevent the government from prosecuting them are therefore not criminals, but many people were persuaded by such arguments at the time.").

308 *See* Stanton Wheeler et al., Sitting in Judgment: The Sentencing of White-Collar Criminals 61–62 (1988); *see also* Coleman, *supra* note 305, at ix ("To many people, white-collar crime is nothing more than a footnote to the 'real' problem of crime in our streets."); *id.* at 2–3 (referring to the debate among sociologists as to whether white-collar crime is "really" crime).

309 *See supra* notes 247–49 and accompanying text.

310 Under NASD Rule 1032(i)(1), the obligation to register rests on the person associated with the member (in this context, on the managing directors individually), rather than on the member itself (JPMorgan Securities LLC). It states that "[e]ach person associated with a member . . . shall be required to register with FINRA as a Limited Representative—Investment Banking." NASD Manual R. 1032(i)(1) (2012).

about FINRA's willingness to sanction those with power and privilege.

4. *Regulatory Capture*

Arguments based on "regulatory capture" are often advanced to explain weak enforcement by regulators.[311] In some sense, self-regulators are inherently "captured," and thus subject to the influence of self-seeking interest groups, because they regulate their own members.[312] Regulatory capture theory may nevertheless help in understanding a self-regulator's enforcement weaknesses.

Applying this theory to FINRA, one might believe that investment bankers, or the firms employing them, have outsized influence over FINRA, enjoying regulatory leniency as a result. However, this argument stands in tension with the organizational structure of most major investment banking firms, which, as financial conglomerates, employ many types of broker-dealers, including traders and financial advisors.[313] Though it is possible that an investment banking firm may seek regulatory leniency for one category of broker-dealer but not for others, it is not apparent why it would do so.[314] It might nevertheless be true that certain firms, such as large broker-dealers, enjoy outsized influence over FINRA.[315] Though plausible, that explanation garners

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311 The concept of regulatory "capture" stems from an economic theory of regulation in which regulation (and its enforcement) is viewed as a product subject to the laws of supply and demand. Favorable regulation may be the result of pressure exerted on the state or regulators by well-organized and cohesive interest groups that are subject to that regulation. *See generally* Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q.J. Econ. 371 (1983); George J. Stigler, *The Theory of Economic Regulation*, 2 Bell J. Econ. & Mgmt. Sci. 3 (1971).

312 *See* Becker, *supra* note 311.

313 *See* Augar, *supra* note 66, at 109–25 (discussing the various activities conducted by large financial firms).

314 It seems unlikely that investment banking firms might seek regulatory leniency for investment bankers but not for traders, for example, given the rising fortunes and influence of some traders in these firms. *See* Stephen M. Davidoff et al., *The SEC v. Goldman Sachs: Reputation, Trust, and Fiduciary Duties in Investment Banking*, 37 J. Corp. L. 529, 544–45 (2012) (describing the increasing influence of traders at Goldman Sachs and the changes in computerization and financial engineering that facilitated that change).

315 In his study of the SEC, Professor Stavros Gadinis showed that large broker-dealers fared better in SEC enforcement actions relative to smaller firms along various dimensions, including the nature of sanctions imposed; the study does not distinguish between actions against investment bankers and those against other firms or individuals. *See* Stavros Gadinis, *The SEC and the Financial Industry: Evidence from Enforcement Against Broker-Dealers*, 67 Bus. Law. 679, 700–14 (2012). FINRA has faced financial media criticism for focusing its regulatory force on small broker-dealers, rather than large broker-dealers. *See, e.g.*, Ben Protess, *After Years of Defending Wall Street Firms, a Transition to Policing Them*, N.Y. Times, Jan. 18, 2011, at B5 ("During the financial crisis, critics say, [FINRA] missed the forest for the trees, cracking down

no support from the evidence in this Article, which suggests weak enforcement activity against investment bankers generally.

One might believe also that FINRA regulation is doomed to fail from the outset because of the nature of self-regulation itself. Some theories do predict that self-regulators have incentives to help their members extract rents at the public expense by, for example, impeding competition.[316] Evidence of weak enforcement against regulatees—such as that provided above—would be consistent with this rent-seeking view of self-regulation. Other theories, however, prescribe the institutional arrangements under which self-regulation may lead to allocative efficiency and thus challenge such a pessimistic view of self-regulation.[317] Professor Anthony Ogus regards the traditional criticisms of self-regulation as "based on a very incomplete picture of self-regulation."[318] In short, no clear theoretical basis exists for concluding that FINRA's weak enforcement against investment bankers flows inevitably from the nature of self-regulation.

5. *Stated Preference for Protecting Investors*

FINRA's stated enforcement priorities—in particular, its emphasis on protecting investors—may also help explain its weak enforcement activity against investment bankers. FINRA claims to "focus on issues that cause real harm to investors,"[319] leading it to devote greater resources to policing broker-dealers performing "investor-facing"

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on small boiler rooms in Florida while ignoring big warning signs on Wall Street."). The evidence in this Article suggests that FINRA overlooks investment bankers in their dealings with clients, whatever the size of their employers.

316 *See* Ogus, *supra* note 38, at 587–93.

317 *See id.* at 594–97; *see also* M. Todd Henderson, *Self-Regulation for the Mortgage Industry* 17 (Univ. of Chi. Coase-Sandor Inst. for Law & Econ., Working Paper No. 638, 2013), *available at* http://ssrn.com/abstract=2241799 (arguing that self-interest compels the financial industry to regulate itself).

318 *See* Ogus, *supra* note 38, at 588 (asserting that the criticisms of self-regulation, while sometimes appropriate, "are based on a very incomplete picture of self-regulation," and that the "modern law and economics literature has been concerned to explore a much broader conception of [self-regulation] and in so doing to identify institutional arrangements which may escape, or meet, the traditional criticisms and which thereby may be conducive to allocatively efficient outcomes").

319 *See, e.g.*, FIN. INDUS. REGULATORY AUTH., FINRA 2011 YEAR IN REVIEW AND ANNUAL FINANCIAL REPORT 1 (2011), *available at* http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p127312.pdf. FINRA's investor protection rationale extends to institutional investors as well as retail investors. For example, FINRA devotes substantial enforcement activity to private placements, transactions in which the investors are generally institutions or high net worth individuals. *See, e.g.*, Ryan Williams, *United States: FINRA Cracks Down on Private Placements*, MONDAQ, http://www.mondaq.com/unitedstates/x/254456/Securities/FINRA+Cracks‡own+on+Private+Placements (last updated July 29, 2013).

functions than those performing "issuer-facing" functions. FINRA's focus on protecting investors may diminish its oversight of investment bankers.

This explanation has its limits, though. FINRA recognizes the need to protect institutional investors—a category of actor little different from investment banking clients. In 1996, FINRA's predecessor reformed its versatile suitability requirements to explicitly extend them to protect institutional investors as well as retail investors.[320] Moreover, nothing in FINRA's statutory mandate requires it to prioritize the interests of investors over those of investment banking clients, or forbids it from protecting the interests of investment bankers' clients.[321]

Relatedly, FINRA may privately dispute whether investment bankers should fall within its authority. Others explicitly raise the issue. For instance, advisors on small M&A transactions have often questioned the appropriateness of the requirement that they register with FINRA.[322] Congress responded recently by proposing to exempt certain M&A advisors to small companies from the requirement to register as broker-dealers, although the SEC preempted the legislation with a 2014 no-action letter providing relief from registration for small M&A advisors.[323] Perhaps this general resistance and questioning of FINRA's authority over M&A advisors has diminished FINRA's willingness to effectively enforce its rules against investment bankers.

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While numerous factors may explain FINRA's weak enforcement record against investment bankers, none justifies it. FINRA may cost-effectively ratchet up its investigative capacity against bankers and develop greater expertise in investment banking.[324] No legitimate regu-

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320 *See infra* notes 338–39 and accompanying text; *see also* Johnson, *supra* note 23, at 3–5.

321 FINRA's rules are only required to be "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, . . . to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest." 15 U.S.C. § 78o-3(b)(6) (2012).

322 *See Client Newsflash: M&A Brokers Receive No-Action Relief from Broker-Dealer Registration*, DAVIS POLK (Feb. 12, 2014), http://www.davispolk.com/ma-brokers-receive-no-action-relief-broker-dealer-registration/ ("The appropriateness of requiring broker-dealer registration for M&A advisers has often been questioned . . . .").

323 *See SEC Provides No-Action Relief for M&A Brokers*, *supra* note 89 (discussing the SEC no-action letter and temporally related legislative efforts).

324 As noted above, FINRA has significant financial resources at its disposal to hire and compensate knowledgeable staff. *See supra* notes 269–71 and accompanying text.

latory purpose is served by either overlooking the misconduct of the privileged and powerful or allowing those regulated to have outsized influence.

C. *Self-Regulation in Context: Other Deterrence Mechanisms*

FINRA's regulation is one mechanism among several in the regulatory framework for investment bankers. This Section assesses the strength of the other mechanisms, which include reputational constraints, private lawsuits by clients, and SEC enforcement activity.

As a general matter, the risk of reputational damage is inadequate to deter investment bankers' misconduct, even though bankers and their firms do value reputations for propriety.[325] The opportunities for misconduct, the massive rewards on offer, the opacity of the circumstances in which misconduct often occurs, and the risk-loving nature of many investment bankers together provide incentives too powerful to be counteracted by the risk of reputational damage.[326] The surprising speed with which publicly disgraced financial professionals can rehabilitate their reputations and careers also casts doubt on the power of the risk of reputational damage to adequately deter misconduct in this context.[327] Firms can also rehabilitate their own reputations and seek to contain any reputational damage by explaining misconduct as isolated in nature or as unlikely to recur, perhaps because the individuals involved have left the firm or internal controls have been updated.[328] Firms and individuals can also attempt to blur the signal sent by any disciplinary action (and thus the potential effect on their reputations) by settling disputes over their conduct on terms that leave uncertainty as to the truth of the allegations against them.

Market developments in recent decades have also weakened the force of reputational constraints on firms. Professor Alan Morrison and his coauthors point to the increasing mobility of individual bankers and the demise of investment banking partnerships, as well as to

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325 For instance, Goldman Sachs claims that its "reputation . . . is one of our most important assets." Goldman Sachs Annual Report, *supra* note 73, at 28.

326 *See supra* Part I.B.4.

327 *See, e.g.*, Andrew Ross Sorkin, *A Reputation, Once Sullied, Acquires a New Shine*, N.Y. TIMES, Feb. 19, 2013, at B1 (describing the speed with which Steven Rattner, a financial executive who paid $16 million to the SEC and New York Attorney General to settle accusations of wrongdoing, has apparently rehabilitated his reputation).

328 *See, e.g.*, Nicola Clark, *Bank Outlines How Trader Hid His Activities*, N.Y. TIMES (Jan. 28, 2008), http://www.nytimes.com/2008/01/28/business/worldbusiness/28bank.html?em&ex=1201669200&en=9787a96b4e941d12&ei=5087%0A (describing a firm's assertion that a rogue trader had acted alone, apparently evading the firm's existing internal controls).

advances in technology on Wall Street, as "undermin[ing] reputation concerns among investment bankers" and as being associated with weakening relationships between banks and their clients.[329] Professor Jonathan Macey goes so far as to assert that "the traditional model of reputation, that predicts that investment banks . . . will put their customers' interest ahead of their own and avoid conflicts of interest, no longer has much, if any, explanatory force."[330]

Consider next the deterrence force of discipline imposed by clients. One may expect investment banking clients, as sophisticated actors, to "fend for themselves," protecting against investment bankers' misconduct without the need for regulatory intervention.[331] Though that notion stands on weaker empirical foundations in the wake of the financial crisis of 2008, given evident failures of institutional investors to protect their interests in the lead-up to the crisis,[332] it is still widely reflected in securities and financial regulatory regimes. The notion has potential application in relationships between investment banking firms and their clients, since clients may attempt to protect themselves against investment bankers' misconduct, such as by including protective terms in engagement letters and underwriting agreements and then enforcing them.

However, several reasons suggest that the notion of clients as able to "fend for themselves" should not control the regulation of relationships between investment banking firms and their clients. To begin, that notion is applicable to the regulation of arm's length

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329 For a study of the evolution of the relationships between investment banking firms and their clients, including a discussion of the weakening force of investment banking firms' reputations, see Morrison et al., *supra* note 150, at 4. *See also id.* at 36 ("Recent events have caused many market observers to question banks' concerns for their reputation . . . . Our study suggests that the seeds for this change in financial markets were planted and took root decades ago.").

330 JONATHAN R. MACEY, THE DEATH OF CORPORATE REPUTATION: HOW INTEGRITY HAS BEEN DESTROYED ON WALL STREET 49 (2013); *see also* Steven Davidoff Solomon, *As Wall St. Firms Grow, Their Reputations Are Dying*, N.Y. TIMES DEALBOOK (Apr. 26, 2011, 3:56 PM), http://dealbook.nytimes.com/2011/04/26/as-wall-st-firms-grow-their-reputations-are-dying/?_php=true&_type=blogs&_r=0 (arguing that reputations are diminishing in significance in the financial services sector).

331 For discussion of the ideological view of institutional actors as able to fend for themselves, see Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025, 1061–65 (2009). *See also* Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After the Jobs Act*, 101 GEO. L.J. 337, 368–71 (2013).

332 *See* Langevoort, *supra* note 296, at 806, 808–11 (explaining the failure of institutional investors to "fend for themselves" in the lead-up to the financial crisis of 2008); Langevoort, *supra* note 331, at 1057, 1061–70 (providing anecdotal evidence of institutional and wealthy individual investors failing to "fend for themselves").

relationships, such as those between sellers of securities and institutional investors. In contrast, the relationships between investment banking firms and their clients are often characterized as fiduciary.[333] Although the beneficiaries of fiduciary duties may contract to protect their interests, we typically do not expect them to fully do so, because beneficiaries characteristically cannot observe or verify the fiduciary's exercise of discretion[334] and will often repose trust and confidence in the agent—and thus not adopt the adversarial posture necessary for arm's length bargaining.[335]

Second, it is far from clear that investment banking clients are generally sophisticated in the necessary sense. Clients fall on a spectrum of sophistication, with some more sophisticated than others.[336] Even those regarded as the most sophisticated may well be unsophisticated in one-off events, such as large-scale M&A deals and initial public offerings—transactions in which they have limited experience.[337] Accordingly, the general sophistication of an actor should not fore-

333 The relationship between an investment bank as financial advisor and its client is characterized as fiduciary, although contractual disclaimers may modify that result. *See* Tuch, *Investment Banks as Fiduciaries*, *supra* note 63, at 488–510; *see also* William W. Bratton & Michael L. Wachter, *Bankers and Chancellors*, 93 TEXAS L. REV. 1, 31–45 (2014). The same result has been asserted in the relationship between investment banks and their securities underwriting clients. *See* Tuch, *Securities Underwriters*, *supra* note 63, at 51–52.

334 *See* Robert H. Sitkoff, *The Economic Structure of Fiduciary Law*, 91 B.U. L. REV. 1039, 1042 (2011) (referring to the principal's inability to "effectively observe or verify" the agent's exercise of discretion).

335 For similar reasons, the notion of clients as sophisticated actors able to "fend for themselves" has limited force in relationships between law firms and their clients. In important ways, a client's relationship with its law firm is analogous to that with its investment banking firm. *See* Tuch, *Investment Banks as Fiduciaries*, *supra* note 63, at 497, 504.

336 Although sparse, some evidence suggests that financial conglomerates regard their corporate clients as falling on a spectrum of sophistication, with some materially more sophisticated than others. *See, e.g.*, *Wall Street and the Financial Crisis*, *supra* note 242, at 28–29 (referring to e-mail correspondence by a Goldman Sachs employee distinguishing among institutional clients on the basis of their sophistication).

337 In the M&A context, former Delaware Chancellor William T. Allen recognized that clients typically have "little or no experience in the sale of a public company . . . [and] [n]aturally, they turn for guidance to their specialist advisors who will typically have had a great deal of relevant experience." William T. Allen, *Independent Directors in MBO Transactions: Are They Fact or Fantasy?*, 45 BUS. LAW. 2055, 2061 (1990). While some may expect legal advisors to corporations to supply the necessary sophistication and oversight of investment banking firms, such advisors cannot be relied upon to do so as a general matter. Many, if not most, of the primary legal advisors to corporations in M&A are repeat advisors to major investment banking firms on securities offerings and financial regulatory matters and in litigation—or desire to advise them on those matters. Many such legal advisors also advise investment banking firms as deal counsel on M&A when they are not engaged to advise the corporations in those transactions. Legal advisors generally lack the incentives necessary to police the activities of investment banking firms in the M&A context.

close the need for other mechanisms of deterrence. FINRA's predecessor recognized this when in 1996, with the SEC's approval, it extended the reach of its suitability duty to institutional customers.[338] In doing so, it recognized differences amongst sophisticated institutional investors, expressly acknowledging that some such investors may be incapable of understanding a "particular investment risk" or may simply "not be exercising independent judgment in making a particular investment decision."[339]

Third, even apparently sophisticated clients may fail to bargain to protect their interests against investment banking firms. As is well known, corporate managers' interests diverge from those of the corporations they manage.[340] Investment banking firms have even sought to exacerbate these agency costs by offering personal incentives to corporate managers to make decisions favoring investment banking firms, possibly at the expense of the corporations they manage.[341] Accordingly, some corporate managers may not bargain forcefully to protect the interests of their corporations, diminishing the force of client discipline. The approach of Delaware courts may have contributed to this. When directors are misled by the self-interested conduct of their investment bankers in M&A transactions, directors may be found to have breached their own fiduciary duties to the corporations they manage.[342] Accordingly, if directors attempt to hold their bankers accountable for misconduct, they may be providing fodder to

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338 *See* Order Approving NASD Suitability Interpretation, 61 Fed. Reg. 44,100 (Aug. 20, 1996).

339 *See id.* at 44,112 ("Other [sophisticated institutional] investors that meet a definition of 'institutional customer' may not possess the requisite capability to understand the particular investment risk, or may not be exercising independent judgment in making a particular investment decision, and so may be largely dependent on the broker-dealer's analysis and recommendation in evaluating whether to purchase a recommended security."); *see also* COFFEE & SALE, *supra* note <CITE _Ref386944995“>, at 677 ("Although institutional investors clearly do not resemble the widows, orphans and retirees in classic suitability cases, they also are legally entitled to the benefits of the rule—at least according to the NASD.").

340 A voluminous literature stemming from the seminal work of professors Adolf Berle and Gardiner Means considers the lack of coincidence between the interests of corporate managers and shareholders. *See generally* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (Legal Classics Library ed. 1993) (1932) (explaining the divergence of interests between corporate management and widely dispersed shareholders).

341 *See, e.g.*, Maynard, *supra* note 157, at 2023–28 (discussing the allocation by investment bankers of stock in "hot" initial public offerings to the senior managers of potential or current investment banking clients). Another more traditional explanation for clients' failures to adequately protect their interests includes the costs of contracting to articulate broad standards of conduct and the costs of enforcing those contracts.

342 *See infra* notes 350–51 (describing how the self-interested conduct of bankers may compromise the integrity of directors' decisionmaking processes in change-of-control transactions).

plaintiffs in actions against themselves. Relatedly, corporate directors face embarrassment when they admit publicly that they were the victims of their investment bankers, another factor diminishing the prospect that they will discipline their bankers through a public lawsuit.[343]

There is reason to believe that clients could bargain significantly harder than they do. Terms in engagement letters and underwriting agreements typically disclaim the existence of fiduciary duties owed to clients and require clients to indemnify investment banking firms for any financial losses the firms may suffer in a transaction.[344] Legal disputes in which clients seek to hold investment banking firms accountable for misconduct are rare.[345]

Fourth, clients—however sophisticated they may be—have no incentive to prevent investment bankers' misconduct that harms third parties, rather than clients themselves. Some misconduct, such as the misuse of nonpublic client information in certain circumstances, may not harm clients directly, but may cause market-wide harm by lowering market liquidity, increasing trading costs, raising the cost of equity capital, and increasing volatility—and possibly also diminishing the accuracy of stock prices.[346]

Finally, legal barriers inhibit clients' ability to protect their interests. Clients lack standing to enforce FINRA's rules; only FINRA may do so.[347] Further, since the Supreme Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*,[348] clients have been limited in their ability to deploy Section 10(b) of the

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343 *See* Maynard, *supra* note 157, at 2061 n.95.

344 *See* Daniel E. Wolf, Kirkland & Ellis LLP, Kirkland M&A Update: Avoiding Liability Pitfalls in Financial Advisory Assignments 1 (2009), *available at* http://www.kirkland.com/siteFiles/Publications/052B1E50C2EC1E679E7F6739C599A01E.pdf ("As the case law has developed, standard language in engagement letters [between investment banking firms and their clients] has continued to evolve in a manner designed to further . . . reduce the likelihood that extracontractual claims against an investment bank would survive court scrutiny and minimize the damages that may be asserted by aggrieved parties."). My thanks to Megan Shaner for drawing my attention to market practices regarding the use of indemnities in engagement letters.

345 Bankrupt clients are a primary exception. *See, e.g.*, EBC I, Inc. v. Goldman, Sachs & Co., 832 N.E.2d 26, 28 (N.Y. 2005) (involving alleged breach of fiduciary duty by investment firm to former underwriting client in pricing its securities).

346 *See supra* note 165 and accompanying text.

347 *See* Ramirez, *supra* note 109, at 548 ("Noticeably absent from the entire scheme of mandatory self-regulation is any authorization of a private right of action for a violation of an SRO [self-regulatory organization] rule or regulation."). However, violations of FINRA rules may be relevant to a finding of scienter in Rule 10b-5 actions. *See id.* at 549.

348 Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994).

Exchange Act, and related Rule 10b-5, in private actions for aiding and abetting liability against investment banking firms.[349] Clients are thus prevented from using some tools that may deter investment bankers' misconduct.

Shareholders—as opposed to the corporate entities they own—also have slim prospects of holding investment bankers accountable. Shareholders typically lack privity of contract to sue investment banking firms for misconduct.[350] They may instead bring claims against corporate directors and officers, claiming that the misconduct of investment bankers compromised directors' performance of their duties.[351] However, the judicial focus in such actions typically falls on directors and officers, and thus the evidentiary record of investment bankers' conduct is not as fully developed as it might be. Shareholders may claim that investment bankers aided and abetted breaches of fiduciary duty by directors and officers, but such claims are difficult to prove,[352] and the constraints of equitable remedies limit courts' ability to effectively punish bankers' misconduct.[353]

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349 *See id.* at 185 (holding that nothing in § 10(b) of the Securities Exchange Act could give rise to liability in private actions for aiding and abetting a violation of the provision).

350 Under Delaware law, for instance, investment banking firms as M&A advisors owe no direct duties to the shareholders of their clients. *See In re* Shoe-Town, Inc. Stockholders Litig., C.A. No. 9483, 1990 WL 13475, at *7 (Del. Ch. Feb. 12, 1990). For discussion of the barriers preventing shareholders from holding investment bankers accountable for advice to their clients, see Bratton & Wachter, *supra* note 333, at 33–36; Fiflis, *supra* note 18, at 499–513. *See also* KIRKLAND & ELLIS LLP, *supra* note 344, at 1 ("Courts have been generally unwilling to find an extracontractual duty owed to shareholders of a target, the likely harmed parties in the event of alleged faulty advice, particularly if the engagement letter and/or fairness opinion itself is clear as to whom advice is being offered and the nature the relationship between the adviser and the recipient parties.").

351 The claim against directors is that the self-interested conduct of bankers compromised the integrity of directors' decisionmaking processes, leading directors to breach their duties under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), to make reasonable decisions for proper purposes. *See In re* El Paso Corp. S'holder Litig., 41 A.3d 432, 439 (Del. Ch. 2012) (discussing *Revlon*).

352 Vice Chancellor Strine (as he was then) has opined, in the context of a claim for aiding and abetting liability against an investment bank, that "it is difficult to prove an aiding and abetting claim." *In re El Paso Corp.*, 41 A.3d at 448. The difficulty stems from the requirement that the defendant "knowing[ly] participat[e]" in the breach of fiduciary duty, a stringent requirement. *See id.* at 448 n.53 (citing Allied Capital Corp. v. GC-Sun Holdings, L.P., 910 A.2d 1020, 1039 (Del. Ch. 2006)). However, in 2014, the Delaware Court of Chancery imposed aiding and abetting liability on an investment banking firm that had been engaged to provide M&A advice for knowingly participating in breaches of fiduciary duties by corporate directors. *See In re* Rural Metro Corp. Stockholders Litig., 88 A.3d 54, 107 (Del. Ch. 2014).

353 Before issuing a preliminary injunction, the remedy typically sought by shareholder plaintiffs, courts must be satisfied not only of the merits of the case, but also that the balance of equities or harms favors issuing the injunction. *See Revlon*, 506 A.2d at 179 (citing Gimbel v. Signal Cos., 316 A.2d 599, 602 (Del. Ch. 1974)). The balance may favor refusing the injunction

Although this study reports no direct evidence of SEC enforcement against investment bankers,[354] one wonders whether the SEC is any more robust than FINRA in disciplining investment bankers' misconduct. Despite possessing the power to enforce FINRA's rules,[355] the SEC regards FINRA as having "primary responsibility" for regulating broker-dealers' activity.[356] As a self-regulatory organization, FINRA is regarded as serving "the first line of defense" in regulating the conduct of market participants.[357] Additionally, FINRA may have direct market knowledge and expertise (though it has not harnessed it in the investment banking context),[358] giving it greater potential effectiveness in regulating the ethics of broker-dealers than the SEC.[359]

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because shareholders would otherwise be denied the chance to consider the deal, despite the deal being the product of unseemly conduct. *See, e.g.*, *In re El Paso Corp.*, 41 A.3d at 450–52. Despite finding that plaintiffs demonstrated a reasonable probability of success on the merits, the court in *In re El Paso Corp.* "reluctantly" denied the preliminary injunction. *Id.* at 452. The court nevertheless observed that "traditional tools of equity may not provide the kind of fine instrument that enables optimal protection of stockholders in this context," and that "[t]he kind of troubling behavior exemplified [by investment bankers, among others,] here can result in substantial wealth shifts . . . that are hard for the litigation system to police." *Id.* at 450.

354 *See supra* Part II.B.

355 *See* 15 U.S.C.§ 78u(d)(1) (2012). The SEC also exercises oversight over FINRA's rulemaking and disciplinary powers. *See id.* § 78s(b)(1). It also supervises FINRA for compliance with federal securities laws and FINRA's own rules. *See id.* § 78(s)(g)(1). For historical analysis of the creation of the NASD and NYSE, see Nagy, *supra* note 19, at 1022–24, and Donna M. Nagy, *Regulating the Mutual Fund Industry*, 1 BROOK. J. CORP. FIN. & COM. L. 11, 34 (2006).

356 *See* SEC BROKER-DEALER STUDY, *supra* note 79, at iv ("FINRA has primary responsibility for examining broker-dealers. The [SEC] also examines broker-dealers, . . . but generally does not examine broker-dealers on a routine basis."); *id.* at A-7 ("FINRA . . . has primary responsibility for the regulatory oversight of a broker-dealer's activity."); *see also* Sale, *supra* note 159, at 161 ("[D]espite its power to enforce SRO rules, the SEC's regulatory philosophy has been relatively hands-off." (footnote omitted)).

357 *See* DEP'T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 122 (2008) ("Self-regulation in financial markets and services is often characterized as the first line of defense in preserving market integrity and protecting against fraud and abuse.").

358 *See supra* Part III.B.2.

359 *See* SEC. & EXCH. COMM'N, *supra* note 293, at 7. The SEC regards self-regulators "as having certain advantages over direct government regulation," including the ability "to bring to bear expertise and intimate knowledge of the complexities of the securities industry and thereby . . . to respond quickly to regulatory problems," and the ability to "adopt and enforce compliance with ethical standards beyond those required by law." *Id.*; *see also supra* notes 55–56 and accompanying text.

Professor Todd Henderson has echoed these views regarding FINRA, describing FINRA's rules as unique in "policing behavior that does not rise to the level of fraud but is nevertheless socially undesirable." Henderson, *supra* note 317, at 6. Professor Henderson also asserts that FINRA rules are able to get "deep in the cracks, where legal rules are too blunt to operate." *Id.* at 17.

FINRA, not the SEC, conducts routine examinations of broker-dealers.[360] Perhaps it is in recognition of these distinctions that the SEC remains "mainly focused on antifraud enforcement"[361] and rarely becomes involved in enforcing FINRA's "just and equitable" rule,[362] despite having jurisdiction to do so.[363] Ultimately, however, an assessment of the SEC's deterrence force requires detailed study of SEC enforcement activity, which is outside the scope of this Article.

In sum, this Article concludes that FINRA regulation likely underdeters investment bankers' misconduct and provides no credible deterrence against such misconduct. In addition, as currently administered, FINRA regulation may well impose burdens greater than the benefits it confers. The Article also preliminarily concludes that the regulatory framework as a whole underdeters investment bankers' misconduct.

IV. Implications

This Part considers implications of the evidence and analysis in the previous Parts. At a minimum, the evidence warrants the SEC examining and determining whether FINRA is satisfactorily discharging its statutory obligation to enforce compliance with its rules, in the absence of any reasonable justification and excuse.[364] Were the SEC

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360 *See supra* note 356 and accompanying text.

361 *See* Dep't of the Treasury, *supra* note 357, at 122 ("Whereas government regulators are mainly focused on antifraud enforcement, [self-regulatory organizations] can adopt and amend industry rules that address a wider range of activity and professional conduct.").

362 *See* James D. Cox et al., Securities Regulation: Cases and Materials 1028 (6th ed. 2009) (observing that "for the most part, these [FINRA 'just and equitable' conduct rules] in and of themselves are outside the ambit of direct SEC regulation").

363 Enforcement by state regulators would appear to have little deterrence force. To avoid duplication of regulatory authority by state and federal regulators, the National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416, preempted many state securities laws, narrowing states' regulatory authority to, among other things, enforce state antifraud legislation. *See* Dep't of the Treasury, *supra* note 357, at 55. The role of state agencies in regulating broker-dealers is subsidiary to that performed by FINRA and the SEC. *See id.* ("Though states could still require broker-dealer registration [after the 1996 reforms], the SEC and the [NASD] . . . would carry out most broker-dealer regulation."). Nevertheless, the question whether state action adequately deters investment bankers' misconduct cannot be ruled out without an empirical assessment of state actions. For an example of state enforcement activity, see Susanne Craig & Ben Protess, *Morgan Stanley Is Fined over Facebook I.P.O. Role*, N.Y. Times, Dec. 18, 2012, at B1 (discussing action by Massachusetts concerning an investment banker's influence over an issuer's dealings with research analysts).

364 Section 19(g) of the Exchange Act requires FINRA to enforce compliance with its own rules. *See* 15 U.S.C. § 78s(g)(1) (2012). This requirement is subject to reasonable justification and excuse by FINRA. *See id.* § 78s(h)(1). Section 19(h) empowers the SEC to sanction FINRA, if it finds that FINRA has violated or is unable to comply with Section 19(g), among

to censure FINRA, it would not be the first time,[365] and it would be heeding the advice of former SEC Chairman William O. Douglas, who acknowledged the need to maintain oversight of self-regulatory enforcement activities. The robustness of self-regulatory enforcement, he said, may require the "[g]overnment . . . [to] keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, [and] ready for use."[366]

The evidence and analysis above also cast doubt on commonly advanced claims regarding FINRA's regulation of broker-dealers and should facilitate a more informed assessment of the potential merits of self-regulation generally. In critiques of the self-regulation of other professionals, including auditors and mortgage brokers, FINRA is cited as an exemplary self-regulator.[367] In congressional hearings that led to the creation of the Public Company Accounting Oversight Board, Congress is said to have "heard much testimony about the securities industry's relatively successful experience with self-regulation and the great benefits that could be gained if the accounting industry were regulated by an accounting analog to the NYSE or the NASD."[368] Congress even recently considered empowering FINRA to provide self-regulation for investment advisers, another category of securities professional.[369] As for the merits of self-regluation gener-

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other provisions. *See id.* § 78s(h). Section 19(h)(1) of the Exchange Act empowers the SEC to sanction FINRA by suspending or revoking its registration as a registered securities association, or by censuring it or imposing limitations on its activities and functions. *See id.* § 78s(h)(1).

365 In 1996, the SEC censured FINRA's predecessor, the NASD, for violating Section 19(g) of the Exchange Act by failing to "enforce rigorously" its rules when aware that its members were using an anticompetitive pricing convention. *See* SEC. & EXCH. COMM'N, *supra* note 293, at 45 & n.98.

366 SELIGMAN, *supra* note 53, at 185 (quoting William O. Douglas).

367 *See, e.g.*, John C. Coffee, Jr., *The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting* 58–59 (Columbia Law Sch., Ctr. for Law & Econ. Studies, Working Paper No. 191, 2001), *available at* http://ssrn.com/abstract=270944 (arguing for auditors to be self-regulated by a body partially modeled on the NASD, the predecessor of FINRA); Henderson, *supra* note 317, at 19–20 (arguing for mortgage brokers to be regulated by a body modeled on FINRA). In its "blueprint" for reform, the U.S. Department of the Treasury cited the "significance and effectiveness [of] the current [self-regulatory organization] model for futures and securities" (a reference to the NASD, FINRA's predecessor) and suggested "[t]hat model could be considered for other areas." *See* DEP'T OF THE TREASURY, *supra* note 357, at 178–79.

368 *See* Nagy, *supra* note 19, at 1022.

369 *See* DIV. OF INV. MGMT., U.S. SEC. & EXCH. COMM'N, STUDY ON ENHANCING INVESTMENT ADVISER EXAMINATIONS: AS REQUIRED BY SECTION 914 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT 29–39 (2011) (suggesting that Congress consider the possibilities of authorizing FINRA to examine dual-registered investment advisers and authorizing a self-regulatory organization, such as FINRA, to examine all SEC-registered investment advisers).

ally, a parliamentary commission in the United Kingdom recently endorsed the creation of a professional body for bankers, identifying the benefits of self-regulation but without identifying the risk of weak regulatory enforcement.[370] The evidence presented in this Article may facilitate a more balanced assessment of FINRA's enforcement record as well as the potential merits of self-regulation generally.

Although this Article's results also cast doubt on the desirability of having FINRA regulating investment bankers at all (because of the negative cost-benefit comparison), this Article does not advocate for the abandonment of self-regulation of investment bankers. Self-regulation offers distinct advantages over other techniques for regulating professional conduct, and thus should be maintained for the reasons it was initially adopted—to regulate ethics more effectively than the broad brush of government regulation.[371] The self-regulation of investment bankers should be enlivened, rather than eliminated, to attempt to achieve its initial promise.

Resource-intensive changes would have the greatest impact. The self-regulatory function for investment bankers could be performed by a newly formed and staffed body with expertise in investment banking—an investment bankers' regulatory authority. It could sit within or outside FINRA. Such a dedicated body is more likely to develop significantly greater expertise in investment banking than FINRA has to date.

The newly formed self-regulator would do well to articulate detailed standards of conduct in the form of canons of professional responsibility for investment bankers.[372] The lack of explicit standards of conduct is hard felt in the M&A arena, the battleground on which finance often plays out. Mergers and acquisitions is a swashbuckling world in which corporations, advised by investment bankers, "battle" for control of firms by deploying their "arsenal" of strategies, including "poison pills," "white knights," and "scorched earth defenses."[373] Though Delaware courts provide guidance on standards of conduct, that guidance comes after the event and often in a highly fact-contin-

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370 *See* 2 UK PARLIAMENTARY BANKING REPORT, *supra* note 4, at 283–323; *see also* 1 UK PARLIAMENTARY BANKING REPORT, *supra* note 4, at 32–39.

371 *See supra* notes 55–56 and accompanying text.

372 FINRA's rulewriting power is subject to approval or disapproval by the SEC. *See* 15 U.S.C. § 78s(b) (2012).

373 *See, e.g.*, WASSERSTEIN, *supra* note 62, at 908 (index listing of defensive measures). The book by Wasserstein, a former investment banker, reads like a battlefield manual, with chapter headings that include "Offense: Battlefield Tactics" and "Defense: Building the Battlements." *Id.* at xii.

gent form that leaves uncertainty for other fact patterns; and many transactions fall outside Delaware's jurisdiction.

In formulating standards of investment banking conduct, the proposed investment banking self-regulator could use the codes of professional conduct drafted by the American Bar Association or American Institute of Certified Public Accountants as models.[374] It could also refer to the code of conduct adopted by the Hong Kong Securities and Futures Commission.[375] To the extent that investment bankers' uncertainty about norms of professional conduct contributes to their misconduct, such a code would serve to diminish that misconduct. It would also aid self-regulatory enforcement officials in sanctioning investment bankers' misconduct, especially if they would be reluctant to sanction conduct in difficult cases in the absence of detailed guidelines.

FINRA has shown recent awareness of the need for rules tailored to investment bankers by proposing a streamlined set of rules for so-called limited corporate financing brokers ("LCFBs"), a category of brokers into which most investment bankers would fall.[376] The rule set largely consolidates those existing FINRA rules that apply to broker-dealers satisfying the definition of an LCFB, while also making some accommodations.[377] It therefore goes in the opposite direction of the reforms recommended here, but it at least acknowledges the need for tailored rules. More detailed guidance tailored to investment

374 For a brief discussion of these materials, see *supra* notes 40–44 and accompanying text. The proposal recommended would canvass the breadth of investment bankers' conduct, rather than the preparation of fairness opinions only. It is thus similar to, but considerably broader than, the investment banking standard-setting board proposed by Professor Steven Davidoff to promulgate and enforce rules and guidelines for fairness opinions and valuation practices in M&A transactions. *See* Steven M. Davidoff, *Fairness Opinions*, 55 AM. U. L. REV. 1557, 1615–19 (2006).

375 *See* SEC. & FUTURES COMM'N OF HONG KONG, CORPORATE FINANCE ADVISER CODE OF CONDUCT (2013), *available at* http://en-rules.sfc.hk/net_file_store/new_rulebooks/h/k/HKSFC3527_787_VER20.pdf. It is apparent from the code's definition of "corporate finance" that the provisions apply to investment banking firms advising on M&A, securities offerings, corporate restructurings, and related matters. *See id.* § 1.2. Although the code lacks legal force, the Securities and Futures Commission states that it may rely on violations of the code to take disciplinary or other actions against investment banking firms. *See id.* § 1.4. Although it articulates principles broadly, the code covers a range of matters including competence, conflicts of interest, the protection of nonpublic information, dealings with clients, and communications with regulators. *See generally id.* §§ 2–8.

376 In the proposed rule set, the LCFB is defined to include brokers that solely engage in one or more enumerated activities, including advising on securities offerings, M&A, or corporate restructurings. *See* FIN. INDUS. REGULATORY AUTH., *supra* note 7, at 3.

377 *See id.* at 3–4.

banking—and the relations between investment bankers and their clients in particular—is needed.

In providing more detailed guidance, the proposed self-regulator could begin with the legal relationship between investment banking firms and their clients. In their engagement letters with clients, firms typically disclaim the existence of fiduciary, agency, or other responsibilities, claiming instead that the relationship is arm's length. Although the legal effect of such clauses is unsettled,[378] the self-regulator would do well to articulate the standards of conduct owed to clients, namely, principals in M&A transactions and issuers of securities. In the absence of contractual disclaimers, are investment banking firms fiduciaries of their clients? If so, what obligations arise? What obligations do investment bankers individually owe to their clients? May their obligations be contractually varied or excluded? While the common law no doubt provides some answers, parties would benefit from clear and detailed guidance from the self-regulator.

The self-regulator could also be more strategic in deploying its existing resources against investment bankers. With three exceptions over the period studied, FINRA disciplinary matters involved low-visibility bankers and transactions.[379] If actions were to be brought against high-visibility bankers, or against bankers acting on landmark transactions, self-regulatory discipline could shift investment bankers' perceptions, raising their awareness of the probability of sanctions and dispelling any notion of themselves as the "untouchables" of broker-dealer regulation. Provided that the actions brought were targeted at clear misconduct, desirable changes in investment bankers' conduct would be expected to follow.[380]

A further enforcement technique would involve the self-regulator pursuing those investment bankers whose publicly disclosed conduct has already attracted opprobrium. Assuming the allegations to be true, it is difficult to believe that the conduct of the investment banker

378 Contractual techniques to modify or exclude fiduciary duties, while commonly employed, have doubtful effect. *See, e.g.*, RESTATEMENT (THIRD) OF AGENCY § 1.02 cmt. b (2006) (stating that agreements by parties negatively characterizing the relationship as not one of agency are not determinative of the status of a relationship).

379 *See supra* notes 243–49 and accompanying text.

380 To avoid confusion, there is no suggestion here that investment bankers' conduct be assessed other than on its merits. The recommendation here concerns the deployment of resources and is consistent with longstanding regulatory approaches. *See, e.g.*, Mary Jo White, Chair, Sec. & Exch. Comm'n, Address at the Council of Institutional Investors Fall Conference: Deploying the Full Enforcement Arsenal (Sept. 26, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539841202#.VAoGhGRdXUY (identifying the SEC's "near-term" enforcement priorities).

in the acquisition of Del Monte Foods (criticized for his involvement in "secretly and selfishly manipulat[ing] the sale process"[381]), or the investment banker advising El Paso (who failed to disclose his material shareholding in Kinder Morgan[382]), would pass professional regulatory muster. Few resources need be expended in detecting apparent misconduct in these types of matters. Relatedly, FINRA's BrokerCheck reports should disclose adverse comments in judicial opinions about investment bankers, especially considering that FINRA encourages investors to review these reports before engaging a broker-dealer, potentially leading investors to view the reports as comprehensive.[383] Currently, investment bankers may suffer harsh judicial criticism and yet enjoy untarnished FINRA professional disciplinary records.

The proposed self-regulator must also undertake greater investigative fieldwork than FINRA apparently has to date. Because clients of investment bankers have little incentive to report their grievances, an investigative approach relying on complaints rather than independent investigation is likely to produce few disciplinary matters.[384] A change in this area must be buttressed by empowering the self-regulator to compel cooperation by a broader range of parties, such as banks and telephone companies. In the absence of such power, FINRA may be hamstrung in its ability to actively investigate matters that clients refuse to pursue, whether due to managerial self-interest, embarrassment, or ignorance.

Other initiatives are more modest, but no less important. The most obvious involves attempting to desirably shape investment bankers' conduct by giving increased regulatory emphasis to instilling an ethical mindset into investment bankers at times of registration and reregistration. For instance, registration and continuing education exams could test investment bankers on their understanding of ethical principles, not simply their technical competence.[385] Mechanisms be-

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381 *See In re* Del Monte Foods Co. S'holders Litig., 25 A.3d 813, 817 (Del. Ch. 2011).

382 *See In re* El Paso Corp. S'holder Litig., 41 A.3d 432, 442 (Del. Ch. 2012).

383 On its website, FINRA claims that the BrokerCheck report "should be the first resource investors turn to when choosing whether to do business or continue to do business with a particular firm or individual." *See FINRA BrokerCheck*, *supra* note 5.

384 *See supra* Part III.B.1.

385 Currently, FINRA requires investment bankers to undertake a continuing education program on the second anniversary of their registration as associated persons and every three years thereafter. *See* FINRA MANUAL R. 1250 (2011); *see also Regulatory Element Training Resources*, FINRA, http://www.finra.org/Industry/Compliance/ContinuingEducation/P120266 (last visited Jan. 11, 2015). The program, referred to as the S101 Continuing Education Program, consists of a firm element (employer-provided) and a regulatory element (FINRA-provided).

yond self-regulation, such as new forms of shareholder actions and reforms to Delaware jurisprudence, may also improve the existing state of affairs, although they are beyond the self-regulatory focus of this Article.

Conclusion

Self-regulation was introduced in the belief that it offered distinct advantages over government regulation in regulating the "ethics and morality" of broker-dealers.[386] That regulatory philosophy is reflected in FINRA having "primary responsibility" for regulating broker-dealers,[387] and requiring broker-dealers to "observe high standards of commercial honor and just and equitable principles of trade."[388] However, FINRA appears to have virtually abdicated its role of enforcing its rules against one important category of broker-dealer: the investment banker. Despite evidence of potentially pervasive misconduct, FINRA imposed remarkably few sanctions on investment bankers during the sixty-six month period studied. That enforcement activity likely underdeterred investment bankers' misconduct and failed to provide any credible deterrence against such misconduct. It may also have imposed burdens greater than the associated benefits. These conclusions are all the more serious given the apparent weaknesses of other deterrence mechanisms against investment bankers, including private and SEC enforcement. Although various factors may explain FINRA's weak enforcement activity, none justifies it.

This Article recommends the formation of a dedicated investment banking regulatory authority. It recommends that the body articulate specific cannons of professional ethics for investment bankers, target instances of misconduct already identified by experts such as Delaware courts, and undertake independent investigative fieldwork with the aid of broad subpoena power. Self-regulation promises much

See Content Outline for the S101 Regulatory Element, FINRA, http://www.finra.org/web/groups/industry/@ip/@comp/@ced/documents/industry/p120307.pdf (last visited Jan. 11, 2015). The regulatory element, in turn, consists of four modules. *Id.* Three of these (communications with the public; suitability; and handling customer accounts, trade, and settlement practices) seem directed to financial advisors or traders rather than to investment bankers. *See id.* at 3–15. The fourth module (new and secondary offerings and corporate finance) is more suited to investment banking, although it is not apparent from FINRA's description of the module whether ethics or accepted industry practices are a topic of study. *See id.* at 15–17.

386 *See supra* note 55 and accompanying text.

387 *See supra* note 356 and accompanying text.

388 FINRA Manual R. 2010 (2008).

in deterring misconduct. If FINRA fails to deliver, policymakers must act to fill the regulatory gap.