



ARTICLE

Regulatory Arbitrage and the Persistence of Financial Misconduct

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Abstract. Financial-advisor misconduct often has devastating consequences, leading lawmakers to seek tightened investor protections at the federal level. But many advisors can choose whether to be regulated under the federal regime or instead be overseen by state insurance regulators, giving advisors with a history of misconduct reason to select the laxer state-level regulatory environment. Despite extensive debate over the regulation of financial advice, no prior work has examined those incentives.

Using a novel dataset, this Article identifies thousands of financial advisors who have committed serious misconduct and exited the federal regulatory regime—yet continue to advise investors, often using state insurance licenses. Because lobbying has blurred the line between financial advice and insurance sales, current law lets wayward advisors continue to provide similar services under state insurance regulators' light touch. We show that advisors who do this are disproportionately likely to harm investors in the future. And they are overwhelmingly male: Women who have committed serious misconduct are more likely to exit financial services entirely.

Our analysis identifies a limit of federal lawmaking in this area. Federal regulators necessarily rely on state regulators, who may become beholden to the interests of the insurance industry itself rather than the public. We show that more than one in ten state legislators who oversee insurance regulation are now, or were previously, in the business

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of selling insurance. We argue that existing tools for federal regulation of advisor misconduct risk the unintended consequence of pushing the worst advisors into poorly regulated state regimes.

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Introduction

In March 2017, the brokerage industry imposed a permanent bar on Frank Black, a longtime financial advisor.¹ Industry authorities concluded that over the previous decade alone, Mr. Black had fabricated and produced false documents, given false testimony, failed to supervise his employees, engaged in excessive trading in his customers' accounts, and recommended unsuitable securities to clients—all claims that Mr. Black denied.² Despite this regulatory sanction, Mr. Black continued to be registered as an insurance producer with the State of North Carolina,³ and the firm he founded ultimately grew to eighty-five financial advisors across forty-eight states.⁴ Until 2020, his firm's website described his decades-long brokerage career, making no mention of his lifetime ban.⁵ Instead, the firm advertised its services by touting Mr. Black's long experience—and his claim that when it comes to giving investment advice, “[c]lient[s come] first, end of story.”⁶

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1. Fin. Indus. Regul. Auth., *Frank Harmon Black*, BROKERCHECK, <https://perma.cc/8ARR-WYWB> (archived Feb. 8, 2022). The type of bar to which Mr. Black is subject is known as a “permanent bar” under securities law. Mr. Black has appealed this bar to the Securities and Exchange Commission (SEC). *Id.*; see also Application for Review, Se. Invs., N.C., Inc., Administrative Proceeding File No. 3-19185 (SEC May 29, 2019), <https://perma.cc/HVR6-MF5H>.
 2. FIN. INDUS. REGUL. AUTH., BROKERCHECK REPORT: FRANK HARMON BLACK 20, 27, 29, 31-32 (2021), <https://perma.cc/EX5L-7WRP>.
 3. *Licensee Lookup Summary: Black, Frank H*, NAT'L ASS'N INS. COMM'RS, <https://perma.cc/PXK5-BRKE> (documenting Mr. Black's insurance-producer registration under North Carolina law).
 4. *About Us*, SE. INVS., <https://perma.cc/TH27-6WWD> (archived Oct. 24, 2020) (“As of January 2019, Southeast has 85 representatives nationwide and is registered in 48 states.”).
 5. *Id.* (“During Frank's sophomore year a Merrill Lynch broker came into his business class and explained what a stock was and what a stock broker does. Frank immediately went out and bought just one share of stock and instantly fell in love with the market. . . . With this story and [thirty years' experience with Merrill Lynch, E.F. Hutton, J.C. Bradford, A.G. Edwards, and Raymond James] behind him, Frank founded Southeast Investments Which brings us to today.”). The website for Southeast Investments was taken down after we released a draft of this Article, but this page, which notes a date of 2020, is still available through the Internet Archive's Wayback Machine. *Id.*
 6. *Id.* To illustrate the lengths to which brokers may go to limit disclosure of their history of misconduct, we note that an attorney for Mr. Black threatened us with “legal remedies” after we released a draft of this Article. See Letter from Alan M. Wolper, Partner, Ulmer & Berne LLP, to authors 3 (Jan. 21, 2022) (on file with authors) (“I suggest that it would be prudent for you to remove any mention of Frank Black or Southeast from your report I want to be clear: both Southeast and Mr. Black are seriously considering what legal remedies might be available to them, whether or not you actually do anything to recant the research report.”); see also Alan Wolper, *I Am “Investigating” the Fact that Claimant's [sic] Lawyers Use BrokerCheck in a Way FINRA Did Not Intend*, JD SUPRA (Feb. 18, 2021), <https://perma.cc/DSE9-92Y6> (describing Mr. Black's claim that “[c]lient[s come] first, end of story.”).
footnote continued on next page

American workers increasingly rely on professional advisors like Mr. Black to plan their financial futures, so advisor misconduct can have dire consequences—especially for vulnerable investors.⁷ Advocates have thus sought to strengthen federal law governing advisor misconduct.⁸ But like Mr. Black, many advisors can choose to be regulated at either the federal or state level, incentivizing advisors—particularly those with a history of misconduct—to seek out laxer state regulatory regimes.⁹ Despite extensive academic and legislative debate over the regulation of financial advice, those incentives have received scant attention.¹⁰

Wolper’s experience “try[ing] to get [clients’] names removed” from attorney advertisements for aggrieved investors based on BrokerCheck entries). Among other things, the attorney noted that Mr. Black is appealing his bar from the securities industry. Although final disposition of Mr. Black’s appeal is still pending, the SEC concluded nearly two years ago that Mr. Black has “not shown a likelihood of success or a serious legal question regarding his challenge to the underlying violations” in his appeal. *Se. Invs., N.C., Inc.*, Exchange Act Release No. 86097, Administrative Proceeding File No. 3-19185, at 4 (June 12, 2019) (order denying stay), <https://perma.cc/HC42-TU3W>. The attorney also stated that Mr. Black currently sells no insurance nor oversees any employees. As of January 28, 2022, the National Association of Insurance Commissioners continues to show that Mr. Black has an active insurance-producer license in North Carolina. *Licensee Lookup Summary: Black, Frank H*, *supra* note 3.

7. For example, the generational shift from defined-benefit pension plans, under which employers are responsible for allocating worker savings to investments, to defined-contribution plans that require workers to make those decisions, makes financial advice increasingly indispensable. *See, e.g.*, Julia Lynn Coronado & Phillip C. Copeland, *Cash Balance Pension Plan Conversions and the New Economy* 1 (U.S. Fed. Rsr. Bd., Fin. & Econ. Discussion Series No. 2003-63, 2003), <https://perma.cc/9XM4-N2UL> (“[T]he share of pension participants covered by [defined-contribution] pensions has grown from less than forty percent in the early 1980s to about 70 percent in the late 1990s.”); *see also infra* text accompanying notes 38-40 (noting that misconduct claims produce settlements of more than half a billion dollars each year and that victims of misconduct are disproportionately older and less educated).
8. *See generally* COUNCIL OF ECON. ADVISERS, EXEC. OFF. OF THE PRESIDENT, *THE EFFECTS OF CONFLICTED INVESTMENT ADVICE ON RETIREMENT SAVINGS* (2015) (documenting the costs of conflicted financial advice); STAFF OF THE U.S. SEC, *STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS* (2011) (reviewing similar work and recommending uniform federal standards in this area).
9. *See infra* Part III.C.
10. Our study draws on important recent work identifying how police officers, clergy, and teachers with histories of misconduct “wander” among jurisdictions. Wandering refers to the phenomenon whereby individuals, particularly those with a history of misconduct, remain in the same profession but under the oversight of a different regulator. *See generally* Ben Grunwald & John Rappaport, *The Wandering Officer*, 129 *YALE L.J.* 1676 (2020) (documenting that officers who commit misconduct “wander” to other law-enforcement agencies); BILLIE-JO GRANT, STEPHANIE B. WILKERSON, DEKOVEN PELTON, ANNE COSBY & MOLLY HENSCHER, *MAGNOLIA CONSULTING, A CASE STUDY OF K-12 SCHOOL EMPLOYEE SEXUAL MISCONDUCT: LESSONS LEARNED FROM TITLE IX POLICY IMPLEMENTATION* (2017) (pointing out that the practice of teacher-offender transfers contributes to significant harm); Claudia Lauer & Meghan Hoyer, *100s of*
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This Article presents the first study of financial advisors who exit federal oversight after committing serious misconduct yet continue to advise investors. We identify thousands of these advisors and show that they are disproportionately likely to proceed under more lenient state-level regulation, thereby exposing investors to harm in the future.¹¹ We also document a significant gender disparity in this phenomenon: These advisors are mostly male. By contrast, female advisors are far less likely to commit misconduct.¹² And if they do commit misconduct, they are more likely to exit the financial-advisory profession altogether than to continue working under a different regulatory regime.¹³

Our findings offer insights for lawmakers now engaged in vigorous debate over the regulation of financial advice. Because advisors can essentially choose to be regulated under either federal or state law, tightening legal standards in one regime can create incentives for advisors to switch to another.¹⁴ And

Accused Priests Living Under Radar with No Oversight, AP NEWS (Oct. 4, 2019), <https://perma.cc/B4FW-9Y5V> (finding that hundreds of priests accused of sexual abuse moved to other churches or positions).

11. See *infra* Part III.C.3 (showing elevated levels of recidivism, on average, for all advisors who exit the Financial Industry Regulatory Authority (FINRA) broker regime but remain regulated financial advisors in another regime, either federal or state).
12. See *infra* Part III.C.2. Our findings are consistent with prior literature showing that women have lower rates of financial misconduct than men. See Mark L. Egan, Gregor Matvos & Amit Seru, *When Harry Fired Sally: The Double Standard in Punishing Misconduct* 40 tbl.1(b) (Nat'l Bureau of Econ. Rsch., Working Paper No. 23242, 2017) (showing that 3.01% of women and 9.08% of men in BrokerCheck have a prior allegation of misconduct).
13. See *infra* Part III.C.2.
14. As we explain in Part II.D below, the overlap between federal securities law and state insurance regulation is more significant than is commonly understood because many insurance products are linked to the value of securities. Consider indexed annuities: The SEC concluded over a decade ago that those products should be federally regulated. *Indexed Annuities and Certain Other Insurance Contracts*, Securities Act Release No. 33-8996, Exchange Act Release No. 34-59221, 74 Fed. Reg. 3137, 3138-40 (Jan. 16, 2009) (codified at 17 C.F.R. pts. 230, 240); see also Christopher Cox, Chairman, SEC, Statement at Open Meeting on Equity-Indexed Annuities (June 25, 2008), <https://perma.cc/XTV5-F8TZ> (taking the unusual step of playing an excerpt from NBC's *Dateline* during an SEC rulemaking meeting to document abusive annuity sales practices). In response, the insurance industry convinced Congress to include a provision in the Dodd-Frank Act exempting them from federal oversight. Robert M. Elconin & Eric L. Marhoun, *Harkin Amendment Welcome Relief For Indexed Products*, BROKER WORLD (Nov. 1, 2010), <https://perma.cc/DC44-CHES> (documenting the insurance industry's efforts to block or overturn the SEC's rule); Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 989J, 124 Stat. 1376, 1949-50 (2010) (codified at 15 U.S.C. § 77c).

although labor markets can discipline advisors who commit misconduct, that effect can be muted if advisors avoid discipline by changing regimes.¹⁵

We offer lawmakers policy alternatives to mitigate the incentives that low-quality advisors have to select lax regulators, and we propose policies to improve market mechanisms for protecting investors. We argue that any regulatory policy must consider not only the risk that increased federal oversight will push bad actors toward state-level regulation, but also the risk of regulatory capture at the state level.¹⁶ For example, we show that 7.5% of state lawmakers who sit on legislative committees overseeing insurance regulators are currently insurance producers, and that 11% of state lawmakers are now, or once were, in the business of selling insurance—a far higher fraction than for comparable professions.¹⁷

This Article proceeds as follows. Part I provides background on the increasingly important role of financial advisors in household investment decisions. Part II analyzes four separate regulatory regimes that license financial advisors and explains why state-level insurance regimes may be particularly vulnerable to regulatory capture. Part III describes our dataset and provides evidence on advisors' incentives to seek out a laxer regulatory regime. Part IV discusses alternatives for policymakers seeking to address the costs of financial-advisor misconduct.

I. The Economics of Financial-Advisor Misconduct

Financial advisors play an important role in individuals' investment decisions. In this Part, we document the broadening scope of financial advisors' responsibility—and the corresponding costs arising from advisor misconduct.

15. See Mark Egan, Gregor Matvos & Amit Seru, *The Market for Financial Adviser Misconduct*, 127 J. POL. ECON. 233, 261-66, 270-71 (2019) (providing evidence that private markets discipline brokers accused of misconduct, as these brokers are more likely to leave the brokerage industry or to work at smaller and less prestigious brokerage firms).

16. See *infra* Part II.D.

17. See *infra* note 134 and accompanying text. As described in Part II.D below, prior literature has argued that insurance is highly susceptible to regulatory capture, the longstanding economic theory that regulatory agencies may become dominated by the interests they purport to regulate rather than the public interest. See *infra* notes 52-56 and accompanying text.

A. The Importance of Financial Advisors

A 2019 survey found that 56.5% of American families relied on a financial advisor for assistance in making borrowing and investment decisions.¹⁸ Although such advice can be expensive, the costs of investing without an advisor can be even higher—especially for unsophisticated consumers.¹⁹ Consumers often turn to advisors to help manage retirement assets, a sector that has grown significantly over the past two decades, from \$11.6 trillion in 2000 to \$39.4 trillion as of December 31, 2021.²⁰ The growth in retirement assets, now representing roughly one-third of all household assets, helps to explain why the number of financial advisors is projected to increase.²¹

Yet unlike doctors or lawyers, financial advisors are not legally required to have a particular professional qualification or license. To be sure, there are some scattered professional designations regulated by organizations, such as Certified Financial Planner (CFP) and Chartered Financial Analyst (CFA),²² and many advisors are required to obtain a particular license to engage in specific tasks.²³ But while millions of individuals work as professional financial advisors, there is no single degree or designation that qualifies one to do that work. Of course, given that advisors provide services ranging from retail life-insurance sales to the ongoing management of state pension funds, the fragmented structure of the modern financial-services industry may not be surprising. Different clients have different financial needs and risk tolerances,

18. Neil Bhutta et al., *Changes in U.S. Family Finances from 2016 to 2019: Evidence from the Survey of Consumer Finances*, FED. RSRV. BULL. (Bd. of Governors of the Fed. Rsrv. Sys., D.C.), Sept. 2020, at 1, 30.

19. On this view, the growth of the financial-advice industry is best explained by growing demand for these services. See Nicola Gennaioli, Andrei Shleifer & Robert Vishny, *Money Doctors*, 70 J. FIN. 91, 92 (2015) (“In our view, financial advice is a service, similar to medicine.”). Particularly for unsophisticated consumers, there is reason to believe that the benefits of financial advice outweigh its costs. See Hans-Martin Von Gaudecker, *How Does Household Portfolio Diversification Vary with Financial Literacy and Financial Advice?*, 70 J. FIN. 489, 505 (2015) (“[T]he largest losses resulting from underdiversification are incurred by those who neither turn to external help with their investments nor have good skills in basic financial-numerical operations and concepts.”).

20. INV. CO. INST., THE U.S. RETIREMENT MARKET, FOURTH QUARTER 2021, at tbl.1 (2022), <https://perma.cc/25BG-VZSQ> (to locate, select “View/Download File,” then select “Table 1”).

21. *Id.*; *Personal Financial Advisors*, U.S. BUREAU LAB. STAT.: OCCUPATIONAL OUTLOOK HANDBOOK, <https://perma.cc/W6DZ-6W8X> (last updated Dec. 16, 2021) (projecting that employment of personal financial advisors will grow 5% from 2020 to 2030).

22. See Derek Silva, *CFA vs. CFP: Which Do You Need?*, SMARTASSET (Sept. 28, 2021), <https://perma.cc/9T93-WSFK>.

23. For a discussion of the licensing requirements for advisors regulated under each regime, see Part II below.

and advisors will require different levels of sophistication and kinds of expertise to serve these clients.

The problem is that consumers do not understand these distinctions. Most Americans experience financial advice as an undifferentiated product, making no distinction between the individuals who execute their stock trades, advise them on their 401(k) investments, and sell them life insurance linked to the performance of a stock-market index—even though each of these three functions is subject to different legal oversight.²⁴ Even though regulators are increasingly aware that consumers do not understand the distinctions between different types of financial advisors,²⁵ lawmakers have historically enacted distinct regulations for each particular regulatory classification.²⁶

This fragmented approach to regulation may contribute to consumers' wariness of the financial-advice profession. One recent survey concluded that the financial-services sector is the least trusted industry in the national economy;²⁷ another survey asked consumers to rank the relative trustworthiness of various professions and found that consumers viewed Uber drivers as more trustworthy than financial advisors.²⁸ The regulatory patchwork may contribute to this mistrust: Anecdotal evidence indicates that consumers believe that their advisors owe them a higher duty of loyalty than

24. As explained in Part II below, the first individual is a “broker-dealer representative,” the second is an “investment-adviser representative,” and the third is an “insurance producer.” Of course, as we discuss in Part III below, any of these individuals could be registered in multiple regimes.

25. STAFF OF THE U.S. SEC, *supra* note 8, at 94-95, 94 n.448, 95 n.449 (noting the “lack of investor understanding and general investor confusion regarding the roles of broker-dealers and investment advisers” and discussing several letters from individuals demonstrating confusion as to the law governing financial advice).

26. For example, during the recent adoption of federal standards governing brokers and investment advisers, the SEC Chairman emphasized that these professionals should be regulated differently—despite evidence that consumers do not view them differently. See Jay Clayton, Chairman, SEC, Statement at Open Meeting on Commission Actions to Enhance and Clarify the Obligations Financial Professionals Owe to Our Main Street Investors (June 5, 2019), <https://perma.cc/E6CV-DNJU> (“[W]hile both broker-dealers and investment advisers play important roles in helping retail investors achieve their long-term financial goals, they do so in significantly different ways Accordingly . . . the obligations applicable to each type of financial professional should reflect these different characteristics.”); STAFF OF THE U.S. SEC, *supra* note 8, at 94 (“[M]any [investors] noted that they did not understand the difference between an investment adviser and a broker-dealer, much less any potential difference in the standards of care.”).

27. See EDELMAN, 2019 EDELMAN TRUST BAROMETER: FINANCIAL SERVICES 8 (2019), <https://perma.cc/3PW5-CRLP>.

28. Anna Prior, *Brokers Are Trusted Less than Uber Drivers, Survey Finds*, WALL ST. J. (July 28, 2015, 7:00 AM ET), <https://perma.cc/CF67-65J7>.

the law in fact requires.²⁹ This leads to potential conflicts and distrust, as a consumer who mistakenly believes her advisor is a fiduciary may feel cheated upon later learning that the advisor did not adhere to a fiduciary standard in their interactions.³⁰

But there's another reason that financial advisors are unpopular with consumers: widespread misconduct. In the next Subpart, we address advisor misconduct in more detail, drawing from the literature documenting the costs misconduct imposes on investors.

B. The Costs of Financial-Advisor Misconduct

According to a recent study, one in thirteen financial advisors has allegations of misconduct.³¹ Among advisors with allegations of misconduct, approximately 25% are repeat offenders.³² These statistics, while striking, probably understate the actual degree of advisor misconduct.³³

Because advisors provide a wide range of services, the term "misconduct" spans a wide range of activities. At one extreme is fraud: forging client signatures, stealing client assets, and the like. But most financial-advisor misconduct is less obviously improper.³⁴ Consider, for example, excessive trading on a client's behalf to maximize an advisor's sales commissions.³⁵

29. See Justin Sevier & Kelli Alces Williams, *Consumers, Seller-Advisors, and the Psychology of Trust*, 59 B.C. L. REV. 931, 936 (2018) ("[A] problematic mismatch can develop between the expectations of the consumer and the behavior of the seller-advisor: the consumer may mistakenly believe that her expectations of trust and confidence with a seller-advisor are legally protected or even practically justified, and may be unaware that the seller-advisor has no legal duty to act in her best interest.").

30. See *id.* at 979-83.

31. Egan et al., *supra* note 15, at 249. For comparison, the annual rate of misconduct among financial advisors is significantly higher than the frequency of corruption of public employees (less than 0.01%), but comparable to the annual incidence of medical malpractice (around 1%). *Id.* at 252-53. Medical malpractice, however, is much more widely distributed throughout the profession than financial-advisor misconduct, which tends to be concentrated in a small percentage of recidivist advisors. *Id.*

32. *Id.* at 251.

33. One reason is that the brokerage industry's oversight authority allows brokers to delete, or "expunge," evidence of prior misconduct complaints from publicly available records of broker histories. Colleen Honigsberg & Matthew Jacob, *Deleting Misconduct: The Expungement of BrokerCheck Records*, 139 J. FIN. ECON. 800, 801 (2021).

34. See *id.* at 809 tbl.2 (showing that fraud is alleged in only 39% of cases in which customers claim that their broker committed misconduct and the broker subsequently applied for expungement).

35. This behavior, known as churning, is a frequent type of alleged misconduct. *Id.* (showing that 6% of cases involved allegations of churning). Because many advisors receive a fee for trades executed on the client's behalf, they are incentivized to excessively trade stocks to earn the resulting fees, rather than to improve the client's financial prospects.

Because there is nothing inherently wrong with an advisor making trades for a client, identifying misconduct requires analyzing whether the trades were intended to benefit the client or maximize commissions. Similarly, although there is evidence that advisors steer clients toward investments that earn lower returns for the consumer but higher commissions for the broker,³⁶ whether that steering amounts to advisor misconduct depends on the facts of the particular case.³⁷

Notwithstanding these ambiguities, reports of advisor misconduct are common—and the costs of that misconduct are significant. One recent study found that the average settlement for customer claims of advisor misconduct between 2005 and 2015 was over \$500,000, and these settlements cumulatively cost advisors nearly half a billion dollars each year.³⁸

Those harmed by financial-advisor misconduct are disproportionately older and less educated. Rates of misconduct are 19% higher in counties that rank below national averages in household income and education.³⁹ And one

36. See, e.g., Daniel Bergstresser, John M.R. Chalmers & Peter Tufano, *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry*, 22 REV. FIN. STUD. 4129, 4130-31 (2009) (“On a risk-adjusted basis, funds sold by brokers underperform funds sold through direct channels—even before subtracting any distribution charges.”); see also Sendhil Mullainathan, Markus Noeth & Antoinette Schoar, *The Market for Financial Advice: An Audit Study* 1-4 (Nat’l Bureau of Econ. Rsch., Working Paper No. 17929, 2012) (describing experimental results showing that advisors steer clients toward less productive investments that produce more fees for the advisor). See generally Mark Egan, *Brokers Versus Retail Investors: Conflicting Interests and Dominated Products*, 74 J. FIN. 1217 (2019) (finding that consumers purchase inferior financial products as a result of advisor incentives).

37. Take, for example, a retiree considering a product known as an equity-indexed annuity with a rate cap of 2% and a fifteen-year “surrender charge” schedule with a 20% penalty. The basic product—an equity-indexed annuity—provides a fixed annual payment with an interest rate linked to a stock-market index and is desirable for many investors. But this product caps the annual interest rate at 2%, depriving the investor of further gains, and imposes a 20% penalty (the “surrender charge”) on those who withdraw the funds before the end of a fifteen-year period. Those terms make this product a poor choice for the retiree, but the advisor selling the product is likely to be rewarded with a commission of around 8%. See Stan Garrison Haithcock, *How Do Annuity Agent Commissions Work?*, BALANCE (updated July 19, 2021), <https://perma.cc/L8JV-8RNG> (“A 10-year [fixed-index annuity (FIA)] might pay an agent 6% to 8%. Some FIAs have a 15-year surrender charge, which can boost agent pay to more than 8%.”). Whether an advisor who makes this sale engages in actionable misconduct is far from clear under existing law. See *infra* Part II.A.

38. Egan et al., *supra* note 15, at 235, 250-51 (finding that the median settlement paid to consumers during this period was \$40,000, the mean was \$550,000, and annual settlements during this period totaled almost half a billion dollars per year).

39. See *id.* at 237-38.

survey of elderly individuals found that, over the past five years, nearly 5% were victims of an investment fraud.⁴⁰

On top of economic costs, evidence shows that victims of financial misconduct suffer psychological harm. The vast majority of misconduct victims subsequently suffer from broken relationships, reputational damage, and stress-related health problems, consequences that reverberate throughout communities.⁴¹ And because financial advisors influence investment allocation decisions, advisor misconduct may result, more broadly, in inefficient allocation of scarce capital resources.⁴²

C. Institutional Bias in Advisor Discipline

In light of the significant costs of advisor misconduct, recent work has considered whether and how advisors may be disciplined for misconduct. Three important insights have emerged from this nascent literature.

First, a significant disciplinary mechanism involves firms considering advisors' past misconduct in making hiring and firing decisions.⁴³ Advisors are more likely to face this discipline when law or practice mandates that they affiliate with firms to provide financial advice.⁴⁴

Second, both firms and advisors respond to this mechanism by self-sorting on the basis of misconduct. As a result, financial advisors who have a history of misconduct are more likely to be hired by firms with higher misconduct rates,

40. Marguerite DeLiema, Martha Deevy, Annamaria Lusardi & Olivia S. Mitchell, *Financial Fraud Among Older Americans: Evidence and Implications* 7 (Nat'l Bureau of Econ. Rsch., Working Paper No. 24803, 2018).

41. See generally Mark Button, Chris Lewis & Jacki Tapley, *Not a Victimless Crime: The Impact of Fraud on Individual Victims and Their Families*, 27 SEC. J. 36 (2014) (describing the results of over 800 interviews with fraud victims and their family members); Umit G. Gurun, Noah Stoffman & Scott E. Yonker, *Trust Busting: The Effect of Fraud on Investor Behavior*, 31 REV. FIN. STUD. 1341, 1342-44 (2018) (discussing how incidents of fraud produce long-lasting trust shocks among investors).

42. Consider, for example, financial advisors who invested their clients' money in Theranos or Enron. Clearly, investing millions of dollars in fraudulent life-sciences or energy companies is not in the interest of society. For a discussion of this issue in the corporate context, see generally Simi Kedia & Thomas Philippon, *The Economics of Fraudulent Accounting*, 22 REV. FIN. STUD. 2169 (2009) (showing, in a theoretical model, that misconduct can distort resource allocation).

43. Egan et al., *supra* note 15, at 265 (finding that advisory firms discipline misconduct and that approximately half of FINRA brokers separate from their firms following misconduct).

44. See, e.g., *Rule 3110. Supervision*, FIN. INDUS. REGUL. AUTH., <https://perma.cc/G4DT-JWT4> (archived Feb. 14, 2022) ("Each [firm] shall establish and maintain a system to supervise the activities of each [broker] that is reasonably designed to achieve compliance with applicable securities laws Final responsibility for proper supervision shall rest with the [firm].").

where the misconduct rate is the percentage of advisors at that firm who have committed misconduct.⁴⁵

Third, this mechanism results in harsher punishment for women than for men. Female advisors who have committed misconduct are 20% more likely to lose their jobs and 30% less likely to find comparable roles in finance within one year than male advisors are.⁴⁶ These findings are consistent with prior work suggesting that female professionals generally face harsher career consequences than their male counterparts do for similar behavior, especially in finance.⁴⁷

D. Financial Advisors and Regulatory Capture

Despite the well-known costs of—and the imperfect disciplinary mechanisms associated with—financial-advisor misconduct, no prior work has examined the incentives that the law gives advisors to seek lax regulatory oversight. There is, however, a growing literature documenting the movement of professionals across fragmented regulatory regimes—including teachers,⁴⁸ clergy,⁴⁹ and police officers⁵⁰—and the tragic consequences that can follow.

45. Egan et al., *supra* note 15, at 288-89 (describing how certain firms “specialize” in misconduct).

46. Egan et al., *supra* note 12, at 3.

47. *See, e.g.*, Vishal K. Gupta, Sandra C. Mortal, Sabatino Silveri, Minxing Sun & Daniel B. Turban, *You’re Fired! Gender Disparities in CEO Dismissal*, 46 J. MGMT. 560, 577-78 (2020) (finding that male CEOs are unlikely to be dismissed when performance is high and that female CEOs are more likely to be dismissed regardless of performance); Robert J. Bloomfield, Kristina Rennekamp, Blake Steenhoven & Scott Stewart, *Penalties for Unexpected Behavior: Double Standards for Women in Finance*, 96 ACCT. REV. 107, 108 (2021) (finding that unexpected employee behavior in the financial-services industry is more likely to result in denying a woman a promotion than a man).

48. *See* Martha Irvine & Robert Tanner, *AP: Sexual Misconduct Plagues US Schools*, WASH. POST (Oct. 21, 2007, 7:18 AM), <https://perma.cc/U7QA-9L6L>. High-profile incidents of teacher sexual-misconduct cases led to “Pass the Trash” legislation designed to prevent predatory teachers from moving from district to district. *See* Katrina Homel, “Pass the Trash” Update: One Year Later, SCH. LEADER (July/Aug. 2019), <https://perma.cc/JGQ8-X7EU>.

49. *See* OFF. OF THE ATT’Y GEN., COMMONWEALTH OF PA., REPORT I OF THE 40TH STATEWIDE INVESTIGATING GRAND JURY 77, 85 (2018) (documenting instances in which priests accused of sexual abuse were reassigned to other jurisdictions without disclosure of prior allegations of misconduct).

50. Grunwald & Rappaport, *supra* note 10, at 1680-83. We draw several of our policy proposals from this work—and especially literature recommending a national database that would allow police departments to identify officers with questionable history in a more efficient and cost-effective manner. *Id.* at 1759-61; *see also* Monica C. Bell, Essay, *Police Reform and the Dismantling of Legal Estrangement*, 126 YALE L.J. 2054, 2137 n.304 (2017).

Drawing on that literature, the next Part explains how advisors have considerable freedom in selecting the regulatory regime that will govern their work. In particular, we show that there is good reason to expect advisors with an extensive history of misconduct to prefer oversight by state insurance regulators rather than by the federal government.⁵¹

One reason is that state insurance regulators have long been thought to be subject to significant industry capture.⁵² While the Securities and Exchange Commission (SEC) and self-regulatory organizations operating subject to SEC oversight are certainly not immune to the economics of industry influence,⁵³ prior literature has argued that state-level insurance oversight is especially susceptible to capture by industry. For example, some have contended that state governments' primacy in insurance oversight invites jurisdictional competition toward a laxer regulatory approach.⁵⁴ Others contend that local

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51. As we explain in Part II.D below, there are several reasons to think that advisors with a history of misconduct would prefer state-level regulation to oversight by FINRA or the SEC—including that federal regulators require detailed public disclosure of an advisor's past misconduct.
52. Jonathan R. Macey & Geoffrey P. Miller, *The McCarran–Ferguson Act of 1945: Reconceiving the Federal Role in Insurance Regulation*, 68 N.Y.U. L. REV. 13, 84 (1993) (tracing the history of state insurance regulation and noting that “[o]ver time . . . the industry established influence over all or nearly all state insurance commissions”); Susan Randall, *Insurance Regulation in the United States: Regulatory Federalism and the National Association of Insurance Commissioners*, 26 FLA. ST. U. L. REV. 625, 639-40 (1999); Daniel Schwarcz, *Regulating Insurance Sales or Selling Insurance Regulation?: Against Regulatory Competition in Insurance*, 94 MINN. L. REV. 1707, 1759-61 (2010).
53. See generally George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971) (arguing that industries may demand regulation, such as control over new entrants that could affect industry competition, for their own benefit); Jean-Jacques Laffont & Jean Tirole, *The Politics of Government Decision-Making: A Theory of Regulatory Capture*, 106 Q.J. ECON. 1089 (1991) (expanding the theory of regulatory capture by considering the motivations of policymakers and the involvement of special-interest groups); PROJECT ON GOV'T OVERSIGHT, REVOLVING REGULATORS: SEC FACES ETHICS CHALLENGES WITH REVOLVING DOOR 2 (2011) (“Between 2006 and 2010, 219 former SEC employees filed 789 post-employment statements indicating their intent to represent an outside client before the Commission.”). For a closer examination of this dynamic in the context of the SEC, compare Maria M. Correia, *Political Connections and SEC Enforcement*, 57 J. ACCT. & ECON. 241, 242 (2014) (providing evidence that politically connected firms are less likely to be targeted by the SEC and that they receive lower monetary penalties if targeted), with Jonas Heese, Mozaffar Khan & Karthik Ramanna, *Is the SEC Captured? Evidence from Comment-Letter Reviews*, 64 J. ACCT. & ECON. 98, 99 (2017) (offering evidence that more politically connected firms draw closer review of securities filings from senior SEC officials).
54. See, e.g., Patricia A. McCoy, *Systemic Risk Oversight and the Shifting Balance of State and Federal Authority over Insurance*, 5 U.C. IRVINE L. REV. 1389, 1397 (2015) (“Historically, two of the rationales for a greater federal role in insurance were lax corporate governance by insurers and inadequate solvency regulation by state insurance commissioners.”); see also Mary Williams Walsh & Louise Story, *Seeking Business, States Loosen Insurance Rules*, N.Y. TIMES (May 8, 2011), <https://perma.cc/DBF5-P5T2>. Of
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insurance regulatory decisions lack the salience necessary to command consumers' attention.⁵⁵ Others cite state insurance commissioners' cozy relationship with industry: One study found that 45-50% of commissioners go directly to insurance industry positions after leaving government.⁵⁶

Whatever the reason, it has long been argued that state insurance regulators are vulnerable to extensive industry influence. And it has also long been understood that financial advisors frequently engage in costly misconduct. No prior work, however, has examined the degree to which the relatively lax regulatory environment provided by the states allows advisors who have engaged in misconduct to continue advising investors. In the next Part, we describe how current laws governing financial advice permit that result.

II. The Law of Financial-Advisor Misconduct

A range of regulatory institutions at both the federal and state level have arisen to govern financial advisors. These regimes generally rely on a mix of disclosure, substantive-conduct regulation, and enforcement. But as we have noted, those institutions frequently take meaningfully different approaches to using those tools, giving advisors reason to select among regimes.

In this Part, we describe four institutional contexts in which investment advice is commonly provided in the United States.⁵⁷ First, we consider broker-

course, states may compete to formulate the most efficient rules rather than those that most favor a particular party. ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 4-5 (1993) (arguing that the flexibility, innovation, and competition afforded through federalism improve corporate law). *But see* Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1509 (1992) (arguing that managerial opportunism and externalities may lead states to adopt undesirable corporate law); Schwarcz, *supra* note 52, at 1713 (noting that in the insurance context, "regulatory competition . . . would tend to exacerbate existing problems with the political economy of insurance regulation"). The federalist approach to insurance regulation in particular, and to regulation more generally, is beyond the scope of this Article. For present purposes, we argue only that there is good reason for financial advisors with an extensive history of misconduct to prefer oversight by state insurance regulators to federal oversight.

55. KENNETH J. MEIER, *THE POLITICAL ECONOMY OF REGULATION: THE CASE OF INSURANCE* 57-61 (1988) (using semiprivate regulation of insurance at the local level in the early 1900s to illustrate the political economy of insurance at work when salience is low).

56. Martin F. Grace & Richard D. Phillips, *Regulator Performance, Regulatory Environment and Outcomes: An Examination of Insurance Regulator Career Incentives on State Insurance Markets*, 32 J. BANKING & FIN. 116, 122 tbl.1 (2008).

57. Although we seek to provide a broad overview of the principal legal regimes governing financial advice, advisors may also be subject to state or federal regulation beyond the scope of this Article. For example, advisors may be separately regulated as fiduciaries under the Employee Retirement Income Security Act of 1974 (ERISA), Pub.

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dealer regulation—that is, the oversight of brokers who execute transactions and offer limited investment advice, often for commission-based compensation. Second, we describe the law governing investment-adviser representatives, who usually provide advice in exchange for fees calculated as a percentage of the assets they manage. Third, we assess institutional oversight of commodities dealers. Finally, we consider the law governing state-registered insurance producers, who provide a wider range of financial services than their title suggests.⁵⁸

A. Regulation of Broker-Dealers

The stockbrokers so familiar in popular culture are, as a legal matter, known as registered representatives of broker-dealer firms.⁵⁹ These individuals represent clients on behalf of a licensed firm, which sponsors their registration with the Financial Industry Regulatory Authority (FINRA) and oversees their conduct. For ease of exposition, we refer to these advisors as FINRA brokers. The broker-dealer firms, in turn, are overseen by both FINRA

L. No. 93-406, 88 Stat. 829 (codified as amended in scattered sections of 26 and 29 U.S.C.); federal rules governing certain activities of national banks, OFF. OF THE COMPTROLLER OF THE CURRENCY, COMPTROLLER'S HANDBOOK: ASSET MANAGEMENT; PERSONAL FIDUCIARY ACTIVITIES 1 (2015) (citing 12 C.F.R. pt. 9); and certain state laws governing the activities of broker-dealers, such as net capital, custody, and financial-reporting obligations, *see, e.g.*, FLA. ADMIN. CODE ANN. r. 69W-600.013 (2021) (defining prohibited business practices for broker-dealers). To be sure, those regulatory regimes can have important implications for the work of financial advisors. For the purposes of this Article, however, we focus on the four principal regulatory regimes that govern advisors' work.

58. For a helpful description of the increasing degree to which insurance producers provide financial-advisory services, *see, for example*, Steve Parrish, *The Life Insurance Agent as Financial Planner*, 72 J. FIN. SERV. PROS. 39, 39 (2018) ("There are two major trends occurring with the insurance and risk management aspects of financial planning. First, many traditional life insurance agents are becoming financial planners, not just in title but in terms of their products, services, and fiduciary responsibilities. Second, financial planning is rapidly transitioning from a sales model to an advisory model. The regulatory, economic, and demographic factors that are driving these trends are less important than their consequences. As life insurance agents become financial planners, and as financial planners become true advisors, the whole area of insurance and risk management has the potential to be better integrated into financial planning. Insurance is no longer just a one-off in planning.").
59. THE WOLF OF WALL STREET (Martin Scorsese dir., 2013) (providing an unflattering depiction of a broker's work); BOILER ROOM (Ben Younger dir., 2000) (same). Although the SEC invests significant resources in broker-dealer oversight, the detection and disclosure of broker misconduct is today largely overseen by FINRA.

and the SEC.⁶⁰ As of 2019, more than 620,000 individuals were employed in this regime.⁶¹

Regulation of FINRA brokers primarily takes three forms: disclosure, enforcement, and substantive-conduct regulation. As to substantive conduct, the law specifies how an advisor may weigh the client's interests against her own when making recommendations. Historically, FINRA brokers have been subject to a "suitability" rule, requiring only that brokers recommend investments based on "reasonable diligence" in understanding an investor's needs. But under a recent SEC rule, FINRA brokers are now required to act in the "best interest" of their clients.⁶² The exact meaning of that standard is a significant source of confusion for investors—and a controversial topic in policy circles.⁶³

As to disclosure, FINRA requires that firms file and regularly update Form U4, which provides information on each broker's background and prior regulatory actions, licenses, customer complaints, and the results of any related arbitration or litigation.⁶⁴ These disclosures are used to assess individuals'

60. Under SEC rules developed pursuant to the Securities Exchange Act of 1934, broker-dealer firms must register with the Commission, disclose on Form BD certain details about the firm and its activities, and update those disclosures on a regular basis. See 15 U.S.C. § 78o; 17 C.F.R. § 240.15b1-1 (2021); see also Div. of Trading & Mkts., *Guide to Broker-Dealer Registration*, SEC (Apr. 2008), <https://perma.cc/X9Y8-ZJP8> (providing detail on disclosures required by registering firms). The SEC also requires firms to submit to oversight by a self-regulatory organization, such as FINRA and any national securities exchange that requires registration for the broker-dealer's activities. See DIV. OF TRADING & MKTS., *supra*. Firms must also pay an initial registration fee. *Schedule of Registration and Exam Fees*, FIN. INDUS. REGUL. AUTH., <https://perma.cc/7MLz-DT6H> (archived Feb. 14, 2022).

61. FIN. INDUS. REGUL. AUTH., 2019 FINRA INDUSTRY SNAPSHOT 2 (2019), <https://perma.cc/6N4F-87DS>.

62. The SEC recently adopted a new rule, known as Regulation Best Interest, that builds on the FINRA suitability rule, imposing additional substantive and disclosure obligations on brokers who provide financial advice. See Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 34-86031, 84 Fed. Reg. 33,318 (July 12, 2019) (codified at 17 C.F.R. § 240.15l-1); *Rule 2111. Suitability*, FIN. INDUS. REGUL. AUTH., <https://perma.cc/34ZS-E73C> (archived Feb. 15, 2022). Compliance with these rules was not required until June 30, 2020. See Regulation Best Interest, 84 Fed. Reg. at 33,400. Thus, brokers in our sample were subject only to the "suitability" standard, under which brokers were expected to have a "reasonable basis" to believe that their advice was suitable for the client based on "reasonable diligence" in ascertaining the client's investment profile and risk tolerance. *Rule 2111. Suitability, supra*.

63. See, e.g., Robert J. Jackson, Jr., Comm'r, SEC, Statement on Final Rules Governing Investment Advice (June 5, 2019), <https://perma.cc/4XSP-PVQM> (dissenting from the adoption of Regulation Best Interest because it formally requires neither brokers nor investment advisers to put clients' interests before their own).

64. See *Rule 1010. Electronic Filing Requirements for Uniform Forms*, FIN. INDUS. REGUL. AUTH., <https://perma.cc/8RDZ-BSE3> (archived Feb. 15, 2022) (detailing Form U4 filing
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fitness to serve as brokers.⁶⁵ In addition, to allow customers and firms to monitor broker misconduct, FINRA records the disclosures in a centralized database known as the Central Registration Depository (CRD) and makes much of that information available to the public through its BrokerCheck website.⁶⁶ BrokerCheck is free, easily accessible, and provides information that meaningfully predicts future misconduct.⁶⁷ Making information freely available in BrokerCheck, which both customers and firms can access when they consider hiring a broker, is thought to aid private monitoring and market discipline.⁶⁸

Misconduct among FINRA brokers is policed through robust inspection and enforcement programs. FINRA conducts roughly 2,300 cycle exams each year to determine whether firms are in compliance with federal securities laws, meaning that many of the roughly 3,500 brokerage firms will be examined annually.⁶⁹ FINRA's examination budget for 2020 alone was over \$270

requirements); Fin. Indus. Regul. Auth., Form U4: Uniform Application for Securities Industry Registration or Transfer (2009), <https://perma.cc/9KYK-GKWU> (providing the thirty-nine-page form that firms are required to file for each registered representative).

65. For example, individuals must undergo an FBI background check and submit to qualification testing as part of the registration and licensing process. *See SEC Approves Consolidated FINRA Rule Regarding Background Checks on Registration Applicants*, FIN. INDUS. REGUL. AUTH., <https://perma.cc/R6US-EUUD> (archived Feb. 15, 2022). FINRA uses this information to assess the applicant's ability to comply with applicable rules and regulations, and it rejects applications from individuals it deems to lack the necessary character and fitness. *See id.* To maintain their license, an advisor must complete ongoing FINRA-developed, computer-based training and remain in good standing. *Continuing Education Program Update: Regulatory Element Questions and Answers*, FIN. INDUS. REGUL. AUTH., <https://perma.cc/G3CK-BYC7> (archived Feb. 15, 2022).
66. Hammad Qureshi & Jonathan S. Sokobin, *Do Investors Have Valuable Information About Brokers?* 2, 4 (Aug. 2015) (unpublished manuscript) (on file with authors) (concluding that publicly available information in BrokerCheck predicts a considerable proportion of broker misconduct).
67. *See, e.g.*, Egan et al., *supra* note 15, at 240 (describing BrokerCheck); Honigsberg & Jacob, *supra* note 33, at 800-04 (discussing the disciplinary information available in BrokerCheck).
68. Honigsberg & Jacob, *supra* note 33, at 801; Qureshi & Sokobin, *supra* note 66, at 4.
69. Fin. Indus. Regul. Auth., *Preparing for a FINRA Cycle Examination 1* (n.d.) <https://perma.cc/E59W-8M5D>. Although both the SEC and FINRA have dedicated groups that inspect broker-dealer firms for compliance with their respective rules, the SEC's team is relatively small. OFF. OF THE INSPECTOR GEN., SEC, REP. NO. 559, *THE SEC'S OFFICE OF BROKER-DEALER FINANCES PROVIDES EFFECTIVE OVERSIGHT, BUT OPPORTUNITIES TO IMPROVE EFFICIENCY EXIST* 7 (2020), <https://perma.cc/A23Z-EY2P> ("[Office of Broker-Dealer Inspections] management explained that the group is relatively small, with only one supervisor . . ."). As of 2019, more than 3,500 broker-dealer firms were registered with FINRA. FIN. INDUS. REGUL. AUTH., *supra* note 61, at 11.

million.⁷⁰ Deficiencies identified in FINRA examinations can be referred to FINRA's enforcement division.⁷¹

Misconduct detected through FINRA inspections can lead to serious consequences. FINRA has the authority to take disciplinary action against brokers, including fines, suspensions, or a bar from the securities industry.⁷² In 2020, FINRA barred 246 individuals, suspended another 375, and referred 970 cases related to fraud or insider trading to criminal authorities. In addition, two firms were expelled and two were suspended.⁷³

FINRA also oversees an extensive arbitration program that allows customers to bring complaints against their brokers.⁷⁴ In 2019 alone, customers filed 2,363 new requests for arbitration through FINRA's dispute-resolution system.⁷⁵ The relatively low cost of arbitration through this system means that clients may be able to arbitrate disputes that would otherwise be too expensive to litigate.⁷⁶

Because FINRA is an industry-funded, self-regulatory organization, both Congress and the SEC have expressed concern that its work may be subject to capture, especially by the largest broker-dealers.⁷⁷ FINRA has changed its

70. FIN. INDUS. REGUL. AUTH., FINRA 2020 ANNUAL BUDGET SUMMARY 6 (2020), <https://perma.cc/R85E-Q9A6> (describing a 2020 member-supervision budget of \$274.6 million).

71. *See generally* *Actions Resulting from Referrals to Federal and State Authorities*, FIN. INDUS. REGUL. AUTH., <https://perma.cc/V24T-LKJF> (archived Feb. 15, 2022) (listing SEC enforcement actions resulting from FINRA referrals).

72. *See, e.g., FINRA Enforcement*, FIN. INDUS. REGUL. AUTH., <https://perma.cc/2SSE-3DBP> (archived Feb. 15, 2022) ("Sanctions [that FINRA may impose] for wrongdoing include fines, suspensions, and, in cases of serious misconduct, bars from the brokerage industry.").

73. *See Statistics*, FIN. INDUS. REGUL. AUTH., <https://perma.cc/Q3QM-XX6M> (archived Feb. 16, 2022).

74. *Overview of Arbitration & Mediation*, FIN. INDUS. REGUL. AUTH., <https://perma.cc/XXS4-TDCK> (archived Feb. 16, 2022).

75. *2019 Dispute Resolution Statistics*, FIN. INDUS. REGUL. AUTH., <https://perma.cc/NY57-35YZ> (archived Feb. 16, 2022).

76. For small claims up to \$10,000, filing fees for FINRA arbitration proceedings will not exceed \$325. *See Rule 13900. Fees Due When a Claim Is Filed*, FIN. INDUS. REGUL. AUTH., <https://perma.cc/7PXJ-46SV> (archived Feb. 16, 2022). Claimants may also elect whether to hire counsel. *How To Find An Attorney*, FIN. INDUS. REGUL. AUTH., <https://perma.cc/L48W-C96F> (archived Feb. 16, 2022).

77. S. DOC. NO. 93-13, at 145 (1973) (identifying "the natural lack of enthusiasm for regulation on the part of the group to be regulated" as a problem with the self-regulatory model); SEC, Concept Release Concerning Self-Regulation, Exchange Act Release No. 34-50700, 69 Fed. Reg. 71,256, 71,256 (Dec. 8, 2004) (to be codified at 17 C.F.R. pt. 240) ("Inherent in self-regulation is the conflict of interest that exists when an organization both serves the commercial interests of and regulates its members or users."). In FINRA's case, the repeated scandals associated with its predecessor, the National Association of Securities Dealers (NASD), doubtlessly contribute to this
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governance structure to address these concerns, including a requirement that the majority of its board be comprised of “public” governors who are, at least in theory, independent from the business interests of any brokerage firm.⁷⁸ FINRA is also subject to extensive SEC oversight. Among other requirements, changes to FINRA rules must be filed with, and approved by, the SEC itself.⁷⁹

B. Regulation of Investment-Adviser Representatives

Individuals who provide financial advice may also be classified as investment-adviser representatives.⁸⁰ Although investment-adviser⁸¹ representatives provide slightly different services than FINRA brokers,⁸² the more significant differences are related to regulatory oversight.

Like FINRA brokers, investment advisers are also sponsored for registration by the firm that employs them.⁸³ Unlike FINRA brokers,

concern. *See, e.g.,* Barbara Black, *Punishing Bad Brokers: Self-Regulation and FINRA Sanctions*, 8 BROOK. J. CORP. FIN. & COM. L. 23, 35-37 (2013) (describing the NASD market-maker collusion scandal of the late 1990s).

78. *FINRA Manual: By-Laws of the Corporation, Article VII, Sec. 4*, FIN. INDUS. REGUL. AUTH., <https://perma.cc/XFQ9-HCTK> (archived Feb. 16, 2022) (“The number of Public Governors shall exceed the number of Industry Governors.”); *FINRA Manual: By-Laws of the Corporation, Article I*, FIN. INDUS. REGUL. AUTH., <https://perma.cc/JTW3-UVTB> (archived Feb. 16, 2022) (defining “Industry Governor” and “Public Governor”). Notwithstanding this requirement, questions remain about the actual independence of FINRA’s public governors. Benjamin P. Edwards, *The Dark Side of Self-Regulation*, 85 U. CIN. L. REV. 573, 576 (2017).

79. 15 U.S.C. § 78s(b)(1); 17 C.F.R. § 240.19b-4 (2020).

80. 15 U.S.C. § 80b-2(a)(11) (defining an investment adviser as a firm or individual engaged in the business of providing securities-related advice, reports, or analysis for compensation).

81. In light of the nomenclature in the statute itself, investment *advisers* (and their individual representatives) regulated under the Investment Advisers Act have historically been referred to with that spelling, whereas the term *advisor* is used for professionals who offer financial advice more generally. This one-letter difference has been the subject of considerable consternation at the SEC. *Compare* Mark Schoeff Jr., *Is Title Reform the Answer to the Fiduciary Debate?*, INVESTMENTNEWS (Mar. 10, 2018), <https://perma.cc/U25F-C4JS> (describing the pros and cons of reforming the use of titles), *with* Greg Iacurci, *The SEC Botched Title Reform. New York Got It Right*, INVESTMENTNEWS (Sept. 11, 2019), <https://perma.cc/4QBV-F95S> (arguing that the SEC should have banned brokers from using the title “adviser”).

82. Investment-adviser representatives often provide ongoing advice and wealth management, whereas FINRA brokers usually receive transaction-based compensation. *See* Joshua Rodriguez, *Broker-Dealer vs. Investment Adviser—What’s the Difference?*, MONEY CRASHERS (Sept. 14, 2021), <https://perma.cc/M9CH-T95Y>.

83. While the SEC requires registration of adviser firms, registration of individuals is generally done at the state level. *See Investment Adviser: FAQs*, N. AM. SEC. ADM’RS ASS’N, <https://perma.cc/VZU2-LZCK> (archived Feb. 16, 2022). Adviser firms are responsible for filing Form U4s with the appropriate jurisdiction and/or self-regulatory

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however, investment advisers are primarily governed by the SEC under a separate statute—the Investment Advisers Act of 1940—and SEC rules promulgated under that law.⁸⁴ For concision, we refer to these individuals as '40 Act advisers. The rules promulgated under this Act require '40 Act advisers to register with either the SEC or the state in which the adviser maintains their principal place of business.⁸⁵ As of 2019, by our own count there were 425,771 active '40 Act advisers.⁸⁶

The Investment Advisers Act of 1940 imposes fiduciary duties on advisers.⁸⁷ '40 Act advisers are required to prioritize their clients' interests and disclose any potential conflicts of interest.⁸⁸ These advisers are also required to file disclosures with the SEC on Form ADV, providing information similar to that collected on Form U4 for FINRA brokers.⁸⁹ Form ADV describes the individual's professional background and conduct, employment history, conflicts of interest, and any disciplinary events.⁹⁰

organization, such as FINRA. See *Form U4*, FIN. INDUS. REGUL. AUTH., <https://perma.cc/8TRV-5BEH> (archived Feb. 16, 2022).

84. Div. of Inv. Mgmt., *General Information on the Regulation of Investment Advisers*, SEC (Mar. 11, 2011), <https://perma.cc/7274-U9TZ>.

85. See 15 U.S.C. §§ 80b-2, -3, -3a.

86. At the firm level, approximately 13,300 investment-adviser firms managing more than \$84 trillion in client assets were registered with the SEC, with another 17,000 registered with state regulators. Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 34-86031, 84 Fed. Reg. 33,318, 33,410 (July 12, 2019). Notwithstanding the SEC's resource limitations, research suggests that SEC oversight of investment advisers is more extensive than that of state regulators. See generally Ben Charoenwong, Alan Kwan & Tarik Umar, *Does Regulatory Jurisdiction Affect the Quality of Investment-Adviser Regulation?*, 109 AM. ECON. REV. 3681, 3682 (2019) (finding an increase in fiduciary violations when the Dodd-Frank Act forced a subset of investment advisers to switch from federal to state regulation).

87. Although the SEC recently reinterpreted the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1, in a fashion that appears to weaken those duties, any effects of that change on the conduct of '40 Act advisers remains to be seen. See Jackson, *supra* note 63 (dissenting from the SEC's interpretation of the Investment Advisers Act).

88. See Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act No. 5248, 84 Fed. Reg. 33,669, 33,672 (July 12, 2019) (discussing the duty of care imposed on investment advisers); Regulation Best Interest, 84 Fed. Reg. at 33,365 (noting, in connection with the adoption of Regulation Best Interest, that the Investment Advisers Act has historically been understood to impose a heightened standard of conduct upon '40 Act advisers).

89. For a detailed description of Form ADV and its history and purpose, see generally SEC, Form ADV (Paper Version) (n.d.), <https://perma.cc/YKS5-2WP3>. For advisory firms, Form ADV requests information on types of clients, advisory services provided, the structure of advisers' compensation, and any disciplinary history of advisers or key personnel. See Colleen Honigsberg, *Hedge Fund Regulation and Fund Governance: Evidence on the Effects of Mandatory Disclosure Rules*, 57 J. ACCT. RSCH. 845, 850 (2019).

90. SEC, *supra* note 89; see also SEC, Form ADV Instruction Page Part 1A (n.d.), <https://perma.cc/MB33-HUR5>.

The SEC makes Form ADV information publicly available on a section of its website known as Investment Adviser Public Disclosure (IAPD).⁹¹ Until recently, limitations on the IAPD website made it difficult to access certain historical information, but the SEC has since contracted with FINRA to operate the IAPD, leading to several upgrades.⁹² Despite the similarities between BrokerCheck and the IAPD, recent empirical work has shown that BrokerCheck attracts far more web traffic.⁹³

Private policing of '40 Act–adviser misconduct is much more limited than in the FINRA regime. Firms act as intermediators, but there is no SEC-sponsored arbitration system. Instead, investment-adviser oversight is conducted largely by the SEC's Office of Compliance Inspections and Examinations (OCIE).⁹⁴ Although OCIE inspected more than 2,000 investment advisers in 2019, that figure amounts to just 15% of the advisers registered with the SEC.⁹⁵ By contrast, recall that FINRA inspected roughly half of broker-dealer firms in that same year.⁹⁶ The frequency of inspections is important, as

91. *Ask and Check*, FIN. INDUS. REGUL. AUTH., <https://perma.cc/33EX-9H7P> (archived Feb. 16, 2022).

92. Following a 2015 recommendation from the SEC's Investor Advisory Committee to "reduce the complexity of background searches" on the BrokerCheck and the IAPD systems, in 2020 the SEC and FINRA took steps to ensure that data were available from both resources via a single search. See Inv. Advisory Comm., *Empowering Elders and Other Investors: Background Checks in the Financial Markets* 15 (2015), <https://perma.cc/4KSU-D4WK>; Rule Change to Amend FINRA Rule 8312 to Allow the Dissemination of IAPD Information Through BrokerCheck, Exchange Act Release No. 34-88760, 85 Fed. Reg. 26,502, 26,504-05 (May 4, 2020).

93. See Colleen Honigsberg & Matthew Jacob, *Deleting Misconduct: The Expungement of BrokerCheck Records* 27 (Stan. Inst. for Econ. Pol. Rsch., Working Paper No. 18-042, 2018), <https://perma.cc/EJ5Z-WZFN> ("As of September 1st, 2018, Alexa data estimated that 37.11% of the 709,991 unique visitors to finra.org over the prior 30 days visited BrokerCheck—making for an estimated 263,478 unique visitors to BrokerCheck. . . . By comparison, sec.gov boasts 2,281,121 unique monthly visitors. Of these, only 3.27% (74,592) visited adviserinfo.sec.gov (the website for background on investment advisers).").

94. In December 2020, the SEC announced that OCIE had been renamed to the Division of Examinations. See Press Release, SEC, *Statement on the Renaming of the Office of Compliance Inspections and Examinations to the Division of Examinations* (Dec. 17, 2020), <https://perma.cc/J86Z-LMEX>. For ease of exposition, throughout this Article we refer to the Division by its historical appellation, OCIE.

95. OFF. OF COMPLIANCE INSPECTIONS & EXAMINATIONS, SEC, 2020 EXAMINATION PRIORITIES 2 (2020), <https://perma.cc/GM37-SPGQ> ("Examinations of registered investment advisers (RIAs) in FY 2019 remained strong at approximately 2,180, covering 15 percent of this population.").

96. The possibility of providing self-regulatory organizations like FINRA with enforcement authority over investment advisers has been repeatedly raised by policymakers for some time, but lawmakers have not yet taken the steps necessary to give FINRA that authority. See *Ensuring Appropriate Regulatory Oversight of Broker-Dealers and Legislative Proposals to Improve Investment Adviser Oversight: Hearing Before the* *footnote continued on next page*

these inspections can uncover malfeasance and raise issues leading to severe consequences for firms and individuals.⁹⁷

While OCIE is staffed by career employees with expertise in oversight, the SEC may itself be subject to capture from the investment-management industry.⁹⁸ Furthermore, the fact that the SEC's budget must be approved annually by Congress gives the industry ample opportunity to influence oversight through legislative lobbying.⁹⁹

C. Regulation of Commodity and Futures Dealers

Financial advisors may also be regulated by the Commodity Futures Trading Commission (CFTC). Under the Commodity Exchange Act, firms and individuals in the derivatives industry are required to register with the CFTC. Because the '40 Act exempts those registered with the CFTC if their business does not "primarily" consist of activities under the SEC's supervision,¹⁰⁰ some

Subcomm. on Cap. Mkts. & Gov't Sponsored Enters. of the H. Comm. on Fin. Servs., 112th Cong. 17-19 (2011) (statement of Richard G. Ketchum, Chairman and CEO, FINRA) (arguing that FINRA oversight supplements SEC oversight and that a self-regulatory body for investment advisers could be beneficial).

97. OCIE inspections can, and often do, result in consequences for firms ranging from a letter identifying problems that the adviser must resolve (known as a deficiency letter) to a referral to the SEC's Division of Enforcement for potential litigation. OFF. OF THE INSPECTOR GEN., SEC, AUDIT NO. 322, COMPLIANCE INSPECTION AND EXAMINATION REFERRALS TO ENFORCEMENT 2 (2001), <https://perma.cc/8PXF-GJYU>. In 2020, more than half of OCIE examinations identified at least one deficiency. *See* OFF. OF COMPLIANCE INSPECTIONS & EXAMINATIONS, SEC, OBSERVATIONS FROM OCIE'S EXAMINATIONS OF INVESTMENT ADVISERS: SUPERVISION, COMPLIANCE, AND MULTIPLE BRANCH OFFICES 3 (2020), <https://perma.cc/7U46-YUHL> ("The vast majority of the examined advisers were cited for at least one deficiency related to [the maintenance of compliance policies and procedures]."). In 2019, more than 5% of inspections resulted in referrals to the SEC's Division of Enforcement. OFF. OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, SEC, 2019 EXAMINATION PRIORITIES 3 (2019), <https://perma.cc/CX8D-KFAH>.

98. *See supra* note 52 (describing empirical studies on SEC capture). In the specific context of investment-management oversight, *see* Stewart L. Brown, *Mutual Funds and the Regulatory Capture of the SEC*, 19 U. PA. J. BUS. L. 701, 701-04 (2017) (contending that the investment-management industry enjoys special sway at the SEC).

99. *See* Elisse B. Walter, Comm'r, SEC, Statement on Study Enhancing Investment Adviser Examinations 1 (Jan. 2011), <https://perma.cc/77J7-Q44E> (describing the SEC's investment-adviser oversight "resource problem [as] severe"); *see also* Jonathan R. Macey, *The Distorting Incentives Facing the U.S. Securities and Exchange Commission*, 33 HARV. J.L. & PUB. POL'Y 639, 644 (2010) (arguing that the SEC must "maintain a base of support within the Congressional budget process" and "maximize its appeal to Congress" (quoting John Sivoletta, *Bureaucratic Decision Making—SEC Enforcement and the Federal Courts' Ideology* 30 (Apr. 12, 2007) (unpublished manuscript) (on file with the Harvard Journal of Law & Public Policy))).

100. Investment Advisers Act of 1940, 15 U.S.C. § 80b-3(b)(6)(A).

advisors may solely operate under the CFTC's institutional framework.¹⁰¹ The CFTC regime features minimal regulation of substantive conduct, instead favoring a disclosure-based "know-your-customer" approach, based on the view that market participants in this area are more sophisticated than those in the securities regime.¹⁰²

Since nearly all those registered with the CFTC must also be registered with the industry's self-regulatory organization, the National Futures Association (NFA), we refer to these individuals as "NFA members." Approximately 3,500 firms and 48,000 individuals were registered with the NFA as of 2019.¹⁰³

Like FINRA and the SEC, the NFA attempts to facilitate private monitoring by providing a consumer-facing, publicly searchable website. This system, the Background Affiliation Status Information Center (BASIC), includes CFTC and NFA regulatory actions, certain customer complaints, and information about arbitration cases involving disputes between NFA members and customers.¹⁰⁴ Unlike BrokerCheck and the IAPD, however, BASIC does not include information on criminal proceedings, actions taken by other regulatory agencies, or financial disclosures.¹⁰⁵

Individuals associated with CFTC-regulated firms are subject to inspections and examinations by both the CFTC's Division of Swap Dealer and Intermediary Oversight (DSIO) and the NFA.¹⁰⁶ Firms that fail to remediate issues identified in inspections may be referred to enforcement staff at either the CFTC or the NFA, which can then investigate and adjudicate allegations of wrongdoing.¹⁰⁷ In 2019, the NFA's enforcement processes resulted in

101. See 7 U.S.C. § 12a.

102. See, e.g., COMMODITY FUTURES TRADING COMM'N & SEC, A JOINT REPORT OF THE SEC AND THE CFTC ON HARMONIZATION OF REGULATION 8 (2009) ("[T]he CFTC requires financial advisers to determine an appropriate level of disclosure particularized to the client based on the 'know your customer' information they have obtained. . . . This approach to suitability is generally premised on the notion that, once customers in the futures industry receive an appropriately tailored disclosure stating that all futures are risky and volatile instruments, they subsequently are in the best position to determine the propriety of a particular futures trade.").

103. NAT'L FUTURES ASS'N, 2019 ANNUAL REVIEW 29 (2019), <https://perma.cc/7NCG-FK8C> (noting that in 2019 there were nearly 200,000 BASIC searches each month).

104. See *BASIC: Terms and Conditions of Use*, NAT'L FUTURES ASS'N, <https://perma.cc/RJH5-Y5XX> (archived Feb. 16, 2022).

105. *Id.*

106. The DSIO has limited resources: As of 2019, it had fewer than eighty employees and a budget of just \$22.9 million. See COMMODITY FUTURES TRADING COMM'N, PRESIDENT'S BUDGET: FY 2021, at 19 (2020), <https://perma.cc/PZS7-YDHC>.

107. For a helpful description of the NFA's process for determining whether and when to refer issues identified during inspections to NFA or CFTC enforcement personnel, see DIV. OF CLEARING & INTERMEDIARY OVERSIGHT, COMMODITY FUTURES TRADING
footnote continued on next page

complaints against thirty-seven individuals, resulting in five expulsions and six suspensions from the commodity-dealing business; during the same period, the CFTC itself filed sixty-nine enforcement actions.¹⁰⁸

While the CFTC, like any other regulator, faces some risk of industry capture, its unique jurisdiction often produces a regulatory agenda emphasizing complex financial products.¹⁰⁹ Nevertheless, even former CFTC officials have expressed concern that its internal processes do not sufficiently protect investors harmed by NFA members.¹¹⁰

D. State Regulation of Insurance Producers

Finally, firms and professionals offering financial advice may also be registered with state insurance regulators. State-level licensing and registration is required for those that sell insurance, who are known as insurance “producers.”¹¹¹ As of 2020, about 2.58 million individuals and 222,467 business entities were licensed to provide insurance services in the United States.¹¹² Although it may be counterintuitive to think of insurance producers as financial advisors, as we explain in this Subpart, insurance professionals across the nation can, and frequently do, provide financial advice.

COMM’N, REVIEW OF THE DISCIPLINARY PROGRAM OF NATIONAL FUTURES ASSOCIATION 15 (2002), <https://perma.cc/ZN2M-7GBR>.

108. NAT’L FUTURES ASS’N, *supra* note 103, at 15; COMMODITY FUTURES TRADING COMM’N, FY 2019 DIVISION OF ENFORCEMENT ANNUAL REPORT 4 (2019), <https://perma.cc/9WTS-Q8PJ>.

109. *See, e.g.*, Andrei Kirilenko, Shawn Mankad & George Michailidis, Do U.S. Financial Regulators Listen to the Public? Testing the Regulatory Process with the RegRank Algorithm 4 (June 30, 2014) (unpublished manuscript), <https://perma.cc/LG6L-BHWG> (examining whether CFTC rulemakings are responsive to public comments and finding that “only comments written by finance professionals such as traders, asset managers, and bankers have a statistically significant predictive effect on the RegRank of the final rules”).

110. *See, e.g.*, Sarah Mui, *Court Records: Retiring Judge Who Said Colleague Was Biased Has His Own Struggles*, ABA J. (Oct. 21, 2010, 12:52 AM CDT), <https://perma.cc/WH4Z-HU8U> (noting that, upon his retirement, a CFTC administrative law judge requested that none of his cases be assigned to a particular colleague because “nearly 20 years ago, [the colleague] came into my office and stated that he had promised [a former CFTC Chair] that we would never rule in a complainant’s favor,” and “[a] review of [the colleague’s] rulings will confirm that he fulfilled his vow”).

111. Insurance producers are also known colloquially as “insurance agents” or “insurance brokers”; the use of those terms varies by jurisdiction. *See, e.g.*, CAL. INS. CODE § 1623 (West 2022) (providing California’s definition of an “insurance broker”); *id.* § 1621 (providing California’s definition of an “insurance agent”).

112. *See* Email from Will McDermott, Representative, Nat’l Ass’n of Ins. Comm’rs, to Colleen Honigsberg, Professor, Stanford L. Sch. (Oct. 8, 2020, 1:13 PM PDT) (on file with authors) [hereinafter Email from Will McDermott to Colleen Honigsberg].

The reason is that many popular insurance products, like indexed and variable annuities, are linked to the value of securities.¹¹³ These products offer the insured individual payouts that depend on the performance of an underlying basket of investments, raising similar questions—and presenting similar risks—as those raised by investment advice more generally.¹¹⁴ As of 2020, Americans had invested more than \$2.5 trillion of retirement assets in annuities alone; for comparison, as noted previously, Americans held an estimated \$39.4 trillion in total retirement assets in 2021.¹¹⁵ For that reason, the overlap between the work of financial advisors and insurance producers is substantial.¹¹⁶

The individual insurance producers who sell these products usually register with the state in which they are located—but because they often operate in multiple states, the majority of insurance producers in our sample are licensed in two or more states.¹¹⁷ Furthermore, insurance producers, unlike

113. See *Indexed Annuities*, FIN. INDUS. REGUL. AUTH., <https://perma.cc/SA4G-8ATT> (archived Feb. 16, 2022) (“Indexed annuities offer a minimum guaranteed interest rate combined with an interest rate linked to a market index, hence the name.”); see also *Variable Annuities*, FIN. INDUS. REGUL. AUTH., <https://perma.cc/QY8Y-93LB> (archived Feb. 16, 2022) (to locate, select “Investor Education”) (“Variable annuities are investment products with insurance features. . . . The value of your annuity depends on how your investment choices perform.”).

114. In an effort to protect consumers who purchase such products, and recognizing the overlap between insurance products and investment advice, the SEC’s investor-education resources dedicate significant space to variable annuities. See SEC, *Variable Annuities*, INVESTOR.GOV, <https://perma.cc/MA37-XXJN> (archived Apr. 17, 2022) (“Variable annuities involve investment risks just like mutual funds do. If the investment choices you selected for the variable annuity perform poorly, you could lose money.”).

115. INV. CO. INST., *supra* note 20, at tbl.1.

116. See Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 34-86031, 84 Fed. Reg. 33,318, 33,376-77 (July 12, 2019) (noting some of the regulatory issues common to brokers selling securities and variable annuities).

117. Some, but not all, states provide insurance producers with “reciprocity”: recognition by State A that licensure in State B is sufficient to sell insurance in State A. See Ass’n of Claims Pros., *State Reciprocity For Licensed Professionals: The Claims Licensing Advancement for Interstate Matters (CLAIM) Act 1 (2020)*, <https://perma.cc/3TM5-RAFD>. Efforts to promote reciprocity and standardization in state-level insurance regulation efforts go at least as far back as the 2013 proposed amendment to the Gramm–Leach–Bliley Act of 1999 (GLB). See National Association of Registered Agents and Brokers Reform Act of 2013 (NARAB), H.R. 1155, 113th Cong. (2013). A version of this amendment was passed into law in 2015; commonly known as NARAB II, the legislation sought to create a clearinghouse for multistate nonresident licensing. 15 U.S.C. § 6751. As of 2018, forty-seven jurisdictions had met the GLB reciprocity mandate. NAT’L ASS’N OF INS. COMM’RS, *STATE LICENSING HANDBOOK* 148 (2018), <https://perma.cc/838Z-FQ32>. As of this writing, however, the NARAB entity does not yet exist, in part because Congress and the President have not yet agreed on the identities of the required thirteen board members. See *National Association of Registered*
footnote continued on next page

FINRA brokers or '40 Act advisers, rarely associate with a single firm; instead, they maintain relationships with a wide range of insurance companies.¹¹⁸ Thus, because insurance producers do not rely on a single firm for sponsorship, licensing, or registration, no single company is held accountable for an insurance producer's conduct, potentially weakening the incentives for firms to monitor their salespeople.¹¹⁹

Also unlike FINRA brokers and '40 Act advisers, insurance producers are not subject to the oversight of a single federal regulator.¹²⁰ Instead, state insurance commissioners coordinate through a private nonprofit organization: the National Association of Insurance Commissioners (NAIC).¹²¹ NAIC model laws are very influential¹²² and widely adopted by state legislatures.¹²³ The NAIC has suggested standards for insurance-producer conduct that mirror the standards that apply to FINRA brokers, but—unlike in the FINRA regime—there is no private arbitration mechanism for enforcing those standards.¹²⁴

Agents and Brokers (NARAB), WHOLESAL & SPECIALTY INS. ASS'N, <https://perma.cc/24PA-VPW9> (archived Feb. 16, 2022).

118. *7 Reasons to Choose an Independent Agent*, MUT. BENEFIT GRP., <https://perma.cc/6HZZ-XLVW> (archived Feb. 16, 2022) (“Independent agents represent many different insurance companies that offer a wide variety of coverage options and price points. Most on average sell for five to eight different insurance companies.”).
119. See, e.g., Jennifer Brown & Dylan Minor, *Misconduct in Financial Services: Differences Across Organizations* 10-11, 13 (Harvard Bus. Sch., Working Paper No. 16-022, 2015) (showing that, while some insurance companies work only with exclusive producers that sell only that insurer's products, a substantial proportion of producers are “[i]ndependent agents [who] are not affiliated with any single insurance company”).
120. See generally NAT'L ASS'N OF INS. COMM'RS, STATE INSURANCE REGULATION 1 (2011), <https://perma.cc/2DNM-M55J> (“Dodd–Frank [created] the Federal Insurance Office . . . to inform Congress on insurance matters. . . . However; the primary state insurance regulatory functions remain as they have been since the enactment of McCarran–Ferguson.”). In general, individuals must pass an exam and background check to obtain a license. *Id.* at 3-4. While licensing requirements vary considerably across the fifty states and the District of Columbia, state-level licenses typically cover a specific category, or “line,” of insurance. See NAT'L ASS'N OF INS. COMM'RS, STATE LICENSING HANDBOOK 43 (2020), <https://perma.cc/X8M7-9VF3>.
121. See *NAIC Model Laws*, NAT'L ASS'N INS. COMM'RS, <https://perma.cc/9YKH-Z2Q9> (last updated June 15, 2021).
122. Some observers have worried that this unusual arrangement raises constitutional concerns. See, e.g., Daniel Schwarcz, *Is U.S. Insurance Regulation Unconstitutional?*, 25 CONN. INS. L.J. 191, 236 (2018) (arguing that states unconstitutionally delegate their power to change insurance laws to the NAIC).
123. For example, a majority of states have adopted the NAIC's Model Producer Licensing Act, which governs standards for producer registration and licensing. See NAT'L ASS'N OF INS. COMM'RS, PRODUCER LICENSING MODEL ACT 218-3 (2005), <https://perma.cc/H5S7-6VVJ>.
124. After the SEC recently adopted new standards on broker conduct, the NAIC approved its own, similar standard in February 2020. But as of July 2021 only fourteen states—Alabama, Arizona, Arkansas, Delaware, Idaho, Iowa, Maine, Michigan, Montana,
footnote continued on next page

Instead, insurance-producer conduct is overseen entirely by the states, to varying degrees of success. While most states have adopted NAIC model standards for analysis, investigations, and exams, survey evidence suggests that significant deficiencies remain due to a lack of uniformity in enforcement.¹²⁵ For example, the frequency of regulatory actions varies widely, with some states taking action against as many as 1 out of 100 registered insurance producers each year and others taking action against as few as 1 out of 1,000.¹²⁶

There is also no consumer-oriented, centralized website containing insurance producers' misconduct records. Unlike FINRA brokers (whose misconduct is disclosed on BrokerCheck), '40 Act advisers (reported on the IAPD), or even NFA members (some misconduct reported on BASIC), insurance producers face little risk of prominent public disclosure of their misconduct.¹²⁷

Nebraska, North Dakota, Rhode Island, Texas, and Virginia—had adopted those changes, with proposals pending in four other states. *See States Race Forward with NAIC Best Interest Adoption*, QUEST CE, <https://perma.cc/FD9U-9SX5> (last updated July 15, 2021). However, other states, such as New York and Massachusetts, previously adopted more stringent standards for insurance-producer conduct. N.Y. INS. L. § 2120 (McKinney 2021); 950 MASS. CODE REGS. 12.207 (2020).

125. *See e.g.*, FED. INS. OFF., U.S. DEP'T OF THE TREASURY, HOW TO MODERNIZE AND IMPROVE THE SYSTEM OF INSURANCE REGULATION IN THE UNITED STATES 53 (2013) (describing a survey in which 78% of participants cited a lack of uniformity in state approaches to oversight as a reason market-conduct practices need improvement).
126. *See, e.g.*, Daniel Schwarcz & Peter Siegelman, *Insurance Agents in the Twenty-First Century: The Problem of Biased Advice*, in RESEARCH HANDBOOK ON THE ECONOMICS OF INSURANCE LAW 62, 63 fig.2.1 (Daniel Schwarcz & Peter Siegelman eds., 2015).
127. The closest parallel is the National Insurance Producer Registry (NIPR), a nonprofit national registry of insurance producers. *About NIPR*, NAT'L INS. PRODUCER REGISTRY, <https://perma.cc/26KL-PRXD> (archived Feb. 16, 2022) ("NIPR is a not-for-profit technology company that provides cost-effective, streamlined, and uniform licensing data and compliance services for insurance professionals."). But the NIPR is producer focused rather than consumer focused; while it offers a wide range of services for producers, it does not offer a consumer-facing portal to provide background information on these individuals akin to the information provided on BrokerCheck and the IAPD. *See supra* notes 66-67, 91. To be sure, the NAIC provides three sources of centralized, online information that may be useful to consumers—but none provides comprehensive data on individual producers' misconduct records. First, one NAIC webpage directs consumers with complaints to the particular state websites where such complaints can be submitted. Second, the NAIC produces reports—combining data from more than fifty jurisdictions—on the disposition of consumer complaints by complaint type. Third, one NAIC online tool allows consumers to search for insurance companies (as opposed to individual producers) and obtain reports related to misconduct complaints against that company. While the NAIC does have searchable databases of further, individual-level data about complaints and regulatory actions known as the Regulatory Information Retrieval System and Special Activities Database, by their terms those databases are currently searchable only by insurance companies and state regulators. *See Inv. Advisory Comm., supra* note 92, at 23-24;
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Instead, consumers seeking information on a state-licensed insurance salesperson must typically search each state's database, contending with considerable variation in the type and quantity of information made available to consumers in each jurisdiction. Relatively few states allow consumers to identify advisor-level misconduct through these databases, and those that do make that process far more burdensome than a search of BrokerCheck or the IAPD.¹²⁸ And unlike BrokerCheck and the IAPD, even the few states that report regulatory misconduct do not necessarily report customer complaints against individuals.¹²⁹

As we have explained, prior literature has argued that insurance regulation is particularly prone to industry capture. Examples of the insurance industry's influence on Congress abound. When the SEC pursued rules that would have regulated indexed annuities as securities, the insurance industry responded by convincing Congress to insert a provision into the Dodd–Frank Act—a statute celebrated for prioritizing consumer protections—that expressly deprived the SEC of regulatory authority over those products.¹³⁰ Indeed, the fact that the insurance industry has largely evaded federal oversight might itself be viewed as evidence of its lobbying prowess.

Whatever one thinks about the insurance industry's influence over Congress, many have argued that insurers' influence over state governments is even more pervasive.¹³¹ As noted above, state insurance commissioners

Daniel Schwarcz, *Transparently Opaque: Understanding the Lack of Transparency in Insurance Consumer Protection*, 61 UCLA L. REV. 394, 414–18 (2014).

128. Recent work, for example, identifies the difficulty in obtaining and using public complaint data from the Texas Department of Insurance, particularly noting the limited distinctions among insurance products in that database. See Brown & Minor, *supra* note 119, at 13 n.21; see also Schwarcz, *supra* note 127, at 417 (describing consumer complaint information as generally “limited and inconsistent”). In our attempts to locate this information for this Article, we found only three states that report insurance-producer misconduct in the standard license-search database.

129. For example, Washington State is one of the few states to include investigations and insurance-commission actions on its consumer-facing portal, but unlike BrokerCheck it does not include complaints from consumers. For example, compare the results for Roger A. Duval on BrokerCheck versus the Washington insurance portal. BrokerCheck shows several customer complaints and highlights that Mr. Duval was ultimately barred from the industry by FINRA. See *Roger Allan Duval*, BROKERCHECK, <https://perma.cc/R2C4-GWZ9> (archived Feb. 16, 2022). By contrast, the Washington insurance portal lists investigations taken by its office, but it does not list consumer complaints or even enforcement actions taken by other regulators. See *Roger A. Duval*, WASH. ST. OFF. INS. COMM'R (Jan. 23, 2022), <https://perma.cc/F555-NEJ9>.

130. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 989J(a), 124 Stat. 1376, 1949-50 (2010) (codified at 15 U.S.C. § 77c).

131. See Randall, *supra* note 52, at 639-40. For an insightful case study of programs designed to address industry capture of state insurance regulators, see Daniel Schwarcz, *Preventing Capture Through Consumer Empowerment Programs: Some Evidence from* *footnote continued on next page*

commonly come from, and return to, the industry itself, giving commissioners incentives to favor industry perspectives.¹³²

Less understood is the insurance industry's significant representation in state legislatures. While previous studies consider the degree of representation some industries enjoy in statehouses (as of 2015, 4.6% of state legislators are farmers and 14.4% are lawyers), to our knowledge, no prior work has considered the degree to which the insurance industry is represented in state legislatures.¹³³

To explore that question, we identified 1,240 state legislators who sit on committees that oversee the insurance industry. Of these, we identified ninety-three, or 7.5%, who are currently registered as insurance producers, and 11% who were previously registered as insurance producers.¹³⁴ These figures reflect a conservative estimate, as we were unable to determine the status of some legislators despite extensive effort.¹³⁵ Notably, the average numbers mask considerable variation. In some states, none of the legislators overseeing insurance regulators have been producers. But some 42% of state legislators overseeing insurance regulation in Oklahoma are now, or once were, insurance producers.

In sum, the widely varying institutional settings regulating financial advice, which differ by legal authority, enforcement intensity, and industry influence, incentivize advisors with a history of misconduct to seek a lax regulatory environment. In the next Part, we provide novel evidence on how advisors respond to those incentives—and the implications of that phenomenon for lawmakers and investors.

Insurance Regulation, in PREVENTING REGULATORY CAPTURE: SPECIAL INTEREST INFLUENCE AND HOW TO LIMIT IT 365, 365-67 (Daniel Carpenter & David A. Moss eds., 2013) (discussing three different models to address potential regulatory capture in the insurance industry).

132. Grace & Phillips, *supra* note 56, at 122 tbl.1 (finding that 45-50% of state insurance commissioners go to insurance-industry positions after leaving government).
133. Jen Fifield, *State Legislatures Have Fewer Farmers, Lawyers; But Higher Education Level*, PEW CHARITABLE TRS.: STATELINE (Dec. 10, 2015), <https://perma.cc/8HFR-R5S8> (documenting the decreasing representation of farmers and lawyers in state legislatures).
134. To identify the percentage of these individuals who are insurance producers, we matched the names of the state legislators in each state with data on producer licenses from the respective state. If the names matched, we conducted additional searches by hand, including of the individual's biography, address, middle name(s), and other identifying information, to determine whether the names referred to the same person.
135. Specifically, we could not determine whether 2.1% of legislators are now producers and whether 5.8% of legislators were formerly producers. In 163 instances, the name of the legislator matched a name on the list of registered insurance producers, but we could not determine whether the individuals were the same despite emailing and calling the legislators in question.

III. Evidence on the Costs of Federalism in Financial Advice

This Part combines evidence from four institutional contexts regulating financial advisors to consider whether and how advisors move among regulatory regimes. We begin with a description of our dataset and then turn to our principal findings. We show that movement among regulatory regimes is common, and that advisors who move among jurisdictions have higher rates of misconduct and recidivism. Finally, we provide striking evidence that these advisors pose a unique threat to state insurance regimes.

A. Financial-Advisor Record Extraction

Our analysis relies on data extracted from four sources, each of which offers information on financial advisors working in a distinct institutional context. We combine data from FINRA's BrokerCheck, which provides data on FINRA brokers; the SEC's IAPD, which covers '40 Act advisers; the NFA's BASIC system, which provides information on NFA members; and state insurance regulator databases, which provide details on insurance producers.

We assembled the dataset in four steps. First, we scraped FINRA's BrokerCheck website, using an algorithm to download all information on BrokerCheck and convert it to a machine-readable format. These data, which include information on all individuals who have been registered representatives of broker-dealers at any point in the past ten years (roughly 1.2 million brokers), are the core of our dataset.¹³⁶ Using the detailed disciplinary history available in BrokerCheck, we determine whether a broker has a record of "misconduct" or "serious misconduct." Following prior literature in this area, we identify a broker as having a record of misconduct if that individual has paid to settle customer disputes, has been terminated by an employer after allegations of improper behavior, has received criminal or regulatory

136. With limited exceptions, BrokerCheck maintains records for all individuals who were actively registered with FINRA at any point in the past ten years. *See generally* Qureshi & Sokobin, *supra* note 66 (providing a helpful history of BrokerCheck). We scraped BrokerCheck in July 2020; thus, many of the 1.2 million unique brokers in our dataset are not currently active, but were active at some point from June 2010 through June 2020.

sanctions, or has been held civilly liable in white collar litigation.¹³⁷ The subset of “serious misconduct” excludes consumer settlements.¹³⁸

Second, we extracted data on ‘40 Act advisers from the SEC’s IAPD website. This site’s structure is similar to that of BrokerCheck. We scraped information, including data on advisor misconduct, on just under 570,000 advisers, all of whom were active at some point in the past ten years.¹³⁹

Third, we obtained information on NFA members by scraping the NFA’s BASIC website. Like BrokerCheck and the IAPD, the NFA’s BASIC website reports prior employment history and qualifications for all registered individuals. But while BASIC provides information on individual-level misconduct, the information is more limited.¹⁴⁰ Our sample includes just over 270,000 unique NFA members.

Finally, in the absence of a single data source, we assembled data on insurance producers by contacting each state’s insurance department. Where possible, we downloaded publicly available data from state websites; if no public data were available, we filed public records requests, supplementing any missing data by scraping state websites or the NAIC’s State Based System.¹⁴¹ Using this process, we identified just over 2.3 million registered insurance producers.¹⁴² Because the NAIC reports that there are 2,576,012 currently

137. See, e.g., Egan et al., *supra* note 15, at 246–47. Because regulatory actions can take years to resolve—and thus be categorized as “final”—we take a conservative approach and include final regulatory events that are disclosed up to two years after leaving a firm. See Terrence Blackburne, John D. Kepler, Phillip J. Quinn & Daniel Taylor, *Undisclosed SEC Investigations*, 67 MGMT. SCI. 3403, 3404 (2021) (finding that the average SEC investigation lasts approximately three years).

138. We are grateful to Jonathan Sokobin and Matthew Kozora for their helpful suggestions with respect to defining and identifying degrees of broker misconduct. Some indicators of misconduct, such as consumer complaints, may be correlated with product complexity, as confused investors may feel that their brokers have recommended unsuitable investments. Therefore, our definition of “serious misconduct” reflects an attempt to standardize misconduct rates across products.

139. Like BrokerCheck, the IAPD maintains records for individuals who have been active at any time in the past ten years. We scraped the IAPD in July 2020, so our data include advisers who were active at some point from June 2010 through June 2020.

140. Unless the incident went through arbitration, customer disputes are generally not reported in BASIC. Further, only regulatory actions from the NFA, CFTC, and exchanges are reported.

141. *tate Based Systems*, NAT’L ASS’N INS. COMM’RS, <https://perma.cc/4BHL-AGQG> (archived Feb. 17, 2022) (providing information from state insurance regulators). Unlike FINRA BrokerCheck or the SEC’s IAPD website, state insurance-producer data include only individuals who are currently registered with the relevant regulator. Thus, we do not have historical data, meaning that we lack information on those individuals who were previously licensed producers but exited the insurance regime before we collected our data in summer 2020.

142. We received data on registered insurance producers from thirty-six states, including major markets for financial advisors such as New York, Texas, Ohio, and Florida. We

footnote continued on next page

registered individual insurance producers nationwide, our sample represents roughly 90% of active insurance producers.¹⁴³ The data include name, address, lines of authority, state of registration, registration start date, registration expiration date, license number, and a unique identifier that is commonly used across states to identify individual producers.¹⁴⁴

B. Dataset Assembly

Our analysis follows the career paths of those who exit the FINRA broker-dealer regime but continue to provide financial advice in another context. We choose to follow those who exit FINRA's regime, as opposed to following those who exit any regime, for two reasons. First, data limitations prevent us from identifying those who have exited the insurance regime; for insurance, our dataset includes only those who are current producers, not former producers. Second, the existing empirical literature on financial advisors examines FINRA brokers, assuming that those who have exited the FINRA regime have exited the industry entirely.¹⁴⁵ Focusing on FINRA brokers allows us to examine this assumption directly.

Thus, we begin with the full sample of individuals who appear in BrokerCheck in any year from 2010 to 2020. We match these individuals to the data described above from the IAPD, NFA's BASIC, and state insurance regulators. This approach allows us to match individuals who appear in BrokerCheck with their current registration status as a '40 Act adviser, an insurance producer, or an NFA member.

did not receive data from a few states for idiosyncratic reasons (for example, Tennessee denied our records request because none of us is a Tennessee resident). Because it is common for insurance producers to register in more than one state, our final sample includes individuals who are not located in any of the thirty-six states for which we received data.

143. See Email from Will McDermott to Colleen Honigsberg, *supra* note 112.

144. The identifier is referred to as a National Producer Number (NPN). If the data we received from the state did not contain this information, we used the partial information we did obtain to scrape the state's website or the NAIC's State Based System (SBS). Of the twenty-five states and territories that have information on the SBS, only some of these states and territories provide searchable registration data. Given the significant fragmentation of registration information and the sparse use of NPNs in some states, scraping the NAIC using the same method as BrokerCheck is not practical. Extracting data on misconduct also presented a number of hurdles. For example, only a handful of states provide misconduct data in a machine-readable format. Thus, although we obtained misconduct data for thirteen states through a combination of hand collection and public-records requests, the data include only regulatory actions and are limited to a small number of states.

145. See, e.g., Egan et al., *supra* note 15, at 240, 265-66 (equating an exit from the BrokerCheck database with leaving the financial-services industry).

The ease of combining BrokerCheck with each of these three data sources varies considerably. Both BrokerCheck and the IAPD identify advisors using a common identifier, making merging the data straightforward.¹⁴⁶ By contrast, neither state insurance regulators nor the NFA's BASIC identify individuals using this same identifier. Thus, we use an algorithm to match individuals from BrokerCheck with those in our insurance-producer and NFA datasets. We first perform a fuzzy match, which, unlike an exact match, identifies pairs that are approximately similar but have minor differences in spelling or punctuation. We match based on first name, last name, and state, and then disambiguate matches using middle name, suffix, city, and ZIP code.¹⁴⁷ To confirm that our methodology yields accurate matches, we manually checked a random sample of 150 matches. This check returned only a 2% error rate, suggesting that our algorithm is highly accurate.

C. Evidence on Flow Across Regulatory Regimes

In this Subpart, we use our unique dataset to examine the frequency with which FINRA brokers cross into other regimes. We first provide evidence that this behavior is widespread. Next, we demonstrate that advisors who engage in this behavior have high rates of misconduct during their time as FINRA brokers, and that those with a history of misconduct have elevated rates of recidivism after exiting the FINRA broker regime relative to those with misconduct who remain. Finally, we show that brokers with misconduct are particularly likely to gravitate to the state insurance regimes.

1. Exit from FINRA oversight and misconduct rates

We begin with summary statistics on registration status for advisors in our sample. Table 1 below reports the final regime with which each advisor is registered and the percentage of advisors in that regime with one or more incidences of misconduct or serious misconduct. Standard errors for each estimate are reported in parentheses.

146. The identifier is a unique number known as a CRD (Central Registration Depository) number. See Sonn L. Staff, *What Is a Broker CRD Number?*, SONN L. GRP. (Feb. 16, 2017), <https://perma.cc/N9HS-5Z59>; see also *Central Registration Depository (CRD)*, FIN. INDUS. REGUL. AUTH., <https://perma.cc/F565-5VQA> (archived Feb. 17, 2022); Press Release, Fin. Indus. Regul. Auth., *FINRA Announces Initiative to Transform CRD, Other Registration Systems* (June 14, 2018), <https://perma.cc/X83E-ZZ8B>; Danielle Klimashousky, *What Is the CRD (Central Registration Depository)?*, SMARTASSET (Jan. 12, 2021), <https://perma.cc/RW54-VY7W>.

147. The fuzzy-match procedure we use produces a match score between 0 and 1. The median match score in our sample is 0.95, consistent with a high accuracy rate.

Figure 1 below offers a visualization of the data in Table 2 by charting the path financial advisors follow when they exit FINRA's oversight regime:

Figure 1
Career Trajectories for Former FINRA Brokers

Figure 1 classifies former FINRA brokers by those with and without serious misconduct. The largest number of individuals with a history of serious misconduct flow into state insurance regimes. By contrast, among individuals with no such history, the largest number of those that exit FINRA oversight provide financial advice as '40 Act advisers—subject to the SEC's oversight.

The flow into insurance is concerning and is consistent with Table 2. As shown in Table 2, the rate of misconduct for those who exit the FINRA regime but continue as insurance producers is more than double that for those who exit our dataset entirely (16.17% vs. 6.99%). Taken together, these trends suggest that “bad” advisors in the FINRA broker regime exit but continue to provide consumer financial services. In particular, the evidence shows, many become insurance producers.

Moreover, not only do a greater percentage of these individuals have a history involving *any* misconduct, but those with at least one report of serious misconduct generally have more misconduct incidents than their peers who remain registered as FINRA brokers. Figure 2 below compares the frequency of misconduct for current and former FINRA brokers:

Figure 2
Misconduct for Current and Former FINRA Brokers

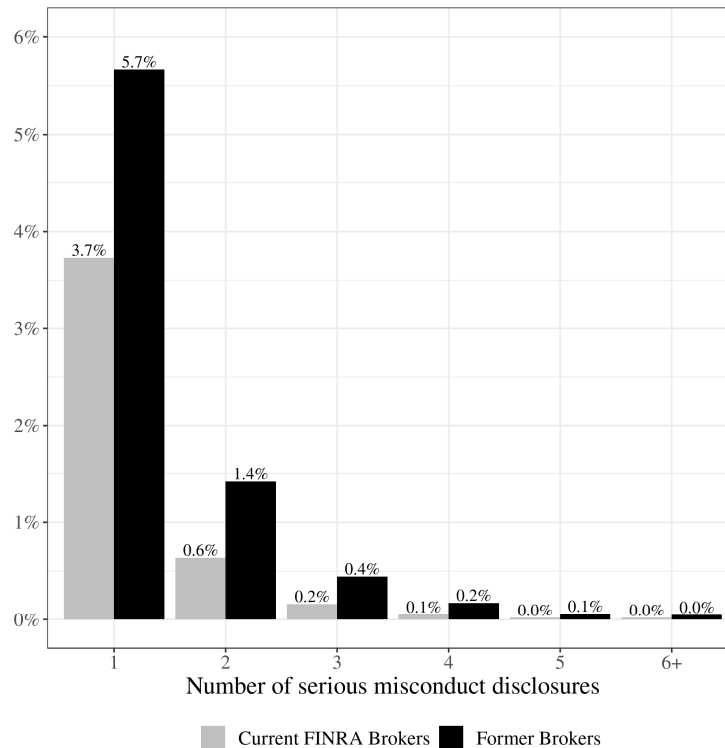


Figure 2 presents the percentage of advisors with each number of serious misconduct disclosures. It classifies advisors based on whether they remain in the FINRA regime or now provide financial advice under a different regime. For example, those who exit the FINRA regime are more than twice as likely to have two reports of serious misconduct in our databases. On balance, our data show that those who exit FINRA's regime but continue to provide financial advice are much more likely to be recidivists compared to advisors who remain subject to FINRA's oversight.

2. Exit from FINRA oversight by gender

As noted in Part II, previous work has shown that women working in financial services are punished more harshly than men following misconduct,

even after controlling for other relevant factors.¹⁵⁰ Building on this work, we examine whether there are differences in the career paths of men and women who exit the FINRA regime. Advisors who join a new regulatory regime, particularly those who do so after incidents of misconduct, essentially get a second chance in their careers.

Table 3 compares the frequency of misconduct and industry exits by gender. To identify each advisor's gender, we merge the advisor's name with data provided by GenderChecker.com, which records the gender (female, male, or unisex) associated with each name in its database.¹⁵¹ We begin with the advisor's first name, but we merge any successive names except the last name until we are able to identify whether the advisor is male or female. For example, consider an individual named Kelly Michael Smith. Kelly is unisex, so our algorithm would identify the individual as male based on the middle name Michael instead. In total, we are able to identify the gender for 95% of our full sample, and the table below is based on this 95%.¹⁵²

150. *See supra* notes 46-48 and accompanying text.

151. The gender associated with each name is compiled from UK census data, where each name is classified as male or female only if all babies with that name have been classified as the same gender.

152. We were unable to identify the gender for 56,453 advisors, most of whom have unisex names. Advisors of Asian descent, in particular, had a relatively low merge rate, as fewer Asian first names are included in GenderChecker's name database.

Table 3
FINRA Exits by Gender

	Count		Female as a Percent of Total
	Female	Male	
Advisors	327,993	818,506	28.61%
with Misconduct	12,667	75,602	14.35%
with Serious Misconduct	8,761	47,883	15.47%
Exited Financial Advisory Services Entirely	94,696	175,919	34.99%
with Misconduct	3,272	11,536	22.10%
with Serious Misconduct	2,966	10,234	22.47%
Exited FINRA but Continued in Financial Services	24,262	93,123	20.67%
with Misconduct	1,323	11,129	10.62%
with Serious Misconduct	919	7,985	10.32%

As shown in Table 3, our results are consistent with past literature on gender differences in financial services.¹⁵³ Women are significantly less likely to have incidents of misconduct (or serious misconduct) than men; women account for roughly 29% of advisors but only around 15% of misconduct. But women with misconduct appear less likely than men to receive a second chance. In particular, women with misconduct (or serious misconduct) reflect only 10% of the advisors who join other regulatory regimes, but 22% of those who exit financial services entirely. This is consistent with the possibility that employers in financial services are less likely to give women with misconduct a second chance.

3. Advisors and recidivism

Of course, the mere fact that advisors have higher levels of *past* misconduct does not necessarily mean that they are more likely to harm investors in the future. And the analysis in Part III.C.1 above reflects only the total number of misconduct disclosures received over an advisor's career, not annualized rates of misconduct. For example, a broker may leave for the insurance regime

¹⁵³ See generally Egan et al., *supra* note 12 (finding harsher penalties for female advisors following misconduct).

because they are barred from the securities industry, or because they merely prefer the flexibility of being their own boss. Therefore, rates of *new* misconduct can be instructive.

Specifically, we consider the annual rates of new misconduct in Table 4 below. As before, we distinguish between advisors with a past history of misconduct and those without—and compare the threat each group poses to investors after they exit the FINRA regime. Table 4 presents those rates for current FINRA brokers and for former FINRA brokers who continue as advisors in another regime, in each case conditional on whether the individual has a record of past misconduct.¹⁵⁴ As before, standard errors are reported in parentheses.

154. For individuals who remain '40 Act advisers, we received misconduct records in the IAPD after they exited the FINRA regime. Those who remain registered as state insurance producers or NFA members after exiting the FINRA regime remain subject to FINRA's jurisdiction for a minimum of two years. *FINRA Qualification and Registration Requirements: Frequently Asked Questions*, FIN. INDUS. REGUL. AUTH., <https://perma.cc/C2SW-3ZLS> (archived Feb. 17, 2022) (explaining that registration as a general securities representative lapses two years after the broker's date of termination, meaning that these individuals remain subject to FINRA's jurisdiction and can return to the industry without additional examination); *see also Form U5*, FIN. INDUS. REGUL. AUTH., <https://perma.cc/CX4G-L54U> (archived Apr. 17, 2022) ("Individuals continue to be subject to the jurisdiction of the regulators with which they were registered for at least two years after registration is terminated."). Thus, to address potential sample-selection bias, in unreported analysis we also examined statistics for former brokers in those regimes limited to the two-year reporting window and found similar trends.

Table 4
Annual Rates of New Misconduct, Conditional on a History of Misconduct¹⁵⁵

	Serious Misconduct		Misconduct	
	No	Yes	No	Yes
Current FINRA Brokers	0.36% (0.002%)	2.00% (0.03%)	0.40% (0.002%)	2.54% (0.02%)
Former FINRA Brokers	0.27% (0.01%)	2.59% (0.07%)	0.24% (0.01%)	2.65% (0.06%)
'40 Act Adviser	0.25% (0.01%)	2.32% (0.10%)	0.22% (0.01%)	2.33% (0.09%)
Insurance Producer	0.24% (0.01%)	2.64% (0.11%)	0.22% (0.01%)	2.83% (0.10%)
NFA Member	0.56% (0.09%)	3.47% (0.66%)	0.36% (0.08%)	3.20% (0.57%)

This evidence deepens our understanding of the higher rates of misconduct we observe among those who exit the FINRA regime. As Table 4 indicates, former FINRA brokers who remain in other regulatory regimes with no history of misconduct have similar or even lower rates of misconduct than current FINRA brokers. By contrast, those who remain in other regimes but *already have* a record of misconduct when they exit the FINRA regime are much more likely to reoffend than brokers currently registered with FINRA who also have a record of misconduct.

Consider, for example, a financial advisor who exits the FINRA regime but remains a registered insurance producer. Assuming that this advisor does not have a history of misconduct upon exiting BrokerCheck, she has a 0.24% chance of reporting misconduct in each year thereafter.¹⁵⁶ By contrast, assuming that this individual already had a history of serious misconduct when she exited BrokerCheck, there is a 2.64% chance that she will incur misconduct in each year thereafter.

155. To provide a clearer comparison, we calculated the percentages in Table 4 based on individuals with only the classification in question. For example, the line representing insurance producers includes only individuals who exited FINRA's broker regime and remained state-registered insurance producers, not those who remained state-registered insurance producers and '40 Act advisers or NFA members.

156. In unreported tests, we found that this figure does not differ significantly from the baseline rate of 0.36% for those who remain FINRA brokers.

In sum, Table 4 suggests that former FINRA brokers who cross into a new regime do not pose an inherent threat to consumers. Instead, only advisors who already have a history of any misconduct when they exit the FINRA broker regime have higher recidivism rates going forward. Recidivism rates are especially high for advisors who continue to work as insurance producers or NFA members.

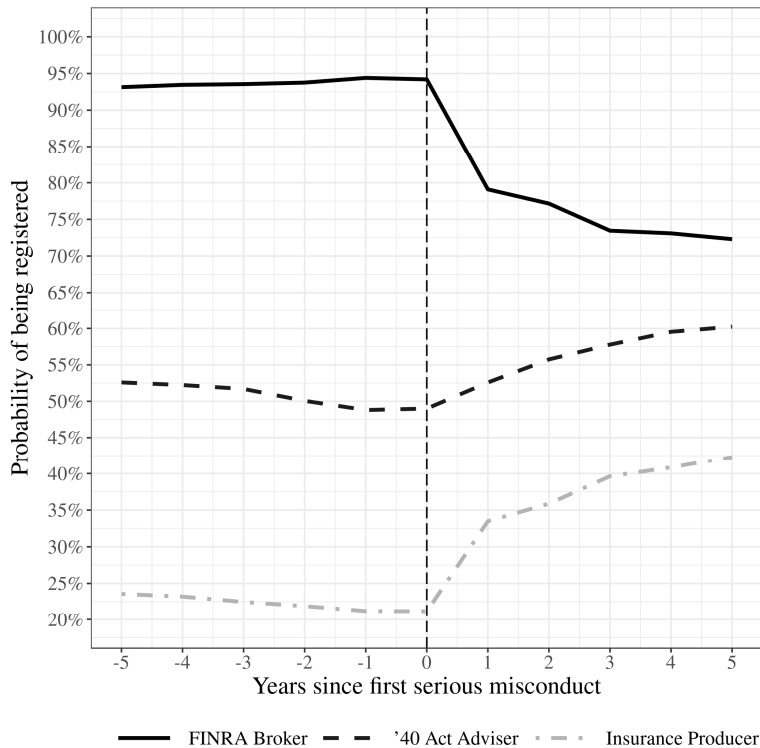
4. The unique role of insurance producers

Although recidivism rates are high for both insurance producers and NFA members, fewer than 1,500 former FINRA brokers remain NFA members. Insurance producers, however, are far more common. Over 50,000 of the former FINRA brokers in our study remain insurance producers.

Further analysis reveals another striking trend regarding insurance producers: Many in our sample opt into the insurance regime following misconduct. As shown in Figure 3 below, the probability that an individual will be registered as an insurance producer actually *increases* from 22% to 34% following serious misconduct. This means that a nontrivial number of individuals with serious misconduct are opting into the insurance regime after misconduct.¹⁵⁷

157. Of course, given our sample construction, a slight increase in the probability that an individual with misconduct will exit the FINRA broker regime but continue to provide financial advice is not unexpected. As a baseline, however, consider that there is only a 2.5% increase in the probability that an individual will be registered as a '40 Act adviser in the first year after committing serious misconduct (from 50% to 52.5%). Using this baseline, the twelve-percentage point increase for insurance producers is striking. Moreover, over the five-year period following an individual's first incident of serious misconduct, the likelihood that the individual will be a '40 Act adviser increases from 50% to 60%—ten percentage points, or an increase of 20%. By contrast, the likelihood that the individual will be an insurance producer increases from 22% to 42.5% over the five-year period following an individual's first incident of serious misconduct—twenty percentage points, or an increase of 93%.

Figure 3
Likelihood of Registration Following Serious Misconduct



This statistic is striking. One concern with summary data, however, is that there may be unobservable differences that make these trends misleading; for example, geographic or firm-level differences might explain what we see. To address those concerns, we used regression analysis to examine the likelihood that an individual adds or removes a registration status conditional on serious misconduct. These regressions control for advisor characteristics¹⁵⁸ and include a fixed effect for the advisor's firm, county, and year.¹⁵⁹ The regression

158. We controlled for years of experience, gender, and the number of qualifying exams the advisor has passed.

159. This fixed effect accounts for potential differences across different firms and local economies, absorbing variation that can arise if, for example, some firms have affiliated insurance or SEC advisory businesses which make it easier for registered representatives to be dual registered or switch registration status. This fixed effect also
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results show that although advisors with serious misconduct are more likely to drop their status as either a '40 Act adviser or an NFA member than those without serious misconduct, this trend is reversed for state insurance producers—instead, advisors with serious misconduct are more likely to *add* a state insurance-producer license.¹⁶⁰

5. Dual registrants

So far, we have assumed that advisors exit the FINRA regime and affirmatively join a new regime. But in practice, individuals are often registered in more than one financial-advisory regime at one time.¹⁶¹ Hence, an advisor may simply exit the FINRA regime and maintain her other license—or, stated colloquially, an advisor may “drop” her “broker hat.”

We examine the frequency of “dropping a hat” in Figure 4. As shown, it is extremely common. Over 90% of those who leave FINRA’s regime but continue to provide financial advice were already registered in another regime prior to exiting the FINRA regime. For example, Figure 4 shows that almost 60% of all such advisors were '40 Act advisers at the time they dropped their FINRA registration—of those with serious misconduct, 63.7% were already '40 Act advisers. Similarly, more than 60% of all former FINRA brokers who exit that regime but remain in another were state-licensed insurance producers at

absorbs any common variation at the state level that may influence the decision to change regulatory regimes (for example, lax state securities or insurance oversight). Finally, the fixed effect absorbs any aggregate variation in regulatory status changes or misconduct (for example, spikes in misconduct investigated after the 2008 financial crisis). If the advisor’s firm is unknown, we considered the individual self-employed for the purposes of our fixed-effects analysis.

160. Formally, in these regressions we consider the probability that individual i at firm j in county l leaves her firm in year t and changes her registration status at $t+1$. Thus, we estimate the linear probability model

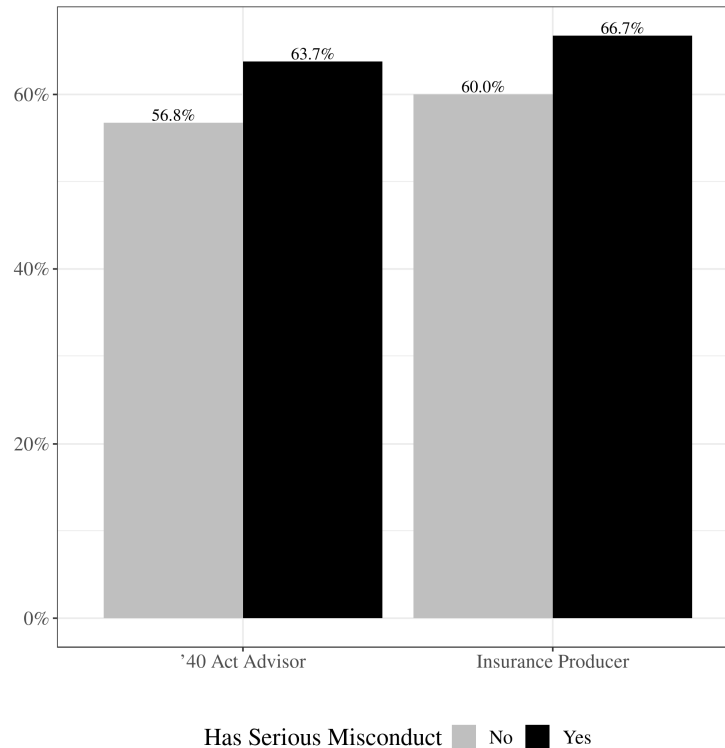
$$\text{Registration Status}_{ijlt+1} = \beta_0 + \beta_1 \text{Serious Misconduct}_{ijlt} + \beta X_{it} + \mu_{jlt} + \varepsilon_{ijlt}$$

where the dependent variable $\text{Registration Status}_{ijlt+1}$ is one of four dummy variables indicating whether the advisor is registered with FINRA, the SEC, a state insurance regulator, or the NFA in year $t+1$. Our main independent variable of interest $\text{Serious Misconduct}_{ijlt}$ is an indicator for whether an individual had a serious misconduct disclosure in year t . X_{it} represents our vector of controls and μ_{jlt} represents our fixed effect. Of course, given our sample construction, these results should not be interpreted to apply generally—that is, we provide no evidence that those with misconduct generally are more likely to become insurance producers. Instead, we focus on the unique trend for insurance producers relative to our other regimes.

161. In our sample, the mean advisor is registered with 1.51 regimes, and the median with 1.

the time they dropped their FINRA registration—of those with serious misconduct, 66.7% were already insurance producers.¹⁶²

Figure 4
Joint Registrations Prior to Exiting the FINRA Broker Regime



In sum, our evidence shows that advisors with a history of misconduct are more likely to be recidivists in the future. Our data also show that, among the advisors who exit the FINRA regime but continue to provide financial advice, those with the most serious history of misconduct are disproportionately likely to end up in state insurance regimes. Finally, we have provided evidence that most such advisors are registered in multiple regimes before they exit

162. The difference between the “Serious Misconduct” and “No Serious Misconduct” categories shown in Figure 4 below is statistically significant for both insurance producers and '40 Act advisers.

FINRA oversight. These findings offer important implications for lawmakers. In the next Part, we consider those implications in detail.

IV. Implications for Investors and Policymakers

This Part explores potential policy alternatives for lawmakers concerned about the incentives created by the fragmented regulation governing financial advisors. As explained below, our evidence suggests that lawmakers should focus on improved regulatory coordination and better facilitation of firm-imposed discipline to address financial-advisor misconduct. In considering these institutional mechanisms, lawmakers should be aware of potential gender disparities in their implementation. Further, because our empirical analysis highlights the unique role that state insurance regulators play in regulating advisor misconduct, our proposals emphasize insurance industry reforms.

A. Regulatory Coordination and Accountability

Fragmented oversight of financial-advisor misconduct—featuring regulatory regimes with markedly different approaches to disclosing and deterring misconduct—gives advisors incentives to wander among regimes. Lawmakers concerned with these incentives should first focus on two straightforward changes to the regulatory landscape: (1) a unified database of advisor misconduct; and (2) accountability among regulators responsible for overseeing advisors.

1. Unified database

The case for a single, searchable database of all individuals who provide financial advice in the United States is strong. This database should include FINRA brokers,¹⁴⁰ Act advisers, insurance producers, and NFA members, as well as additional licensed professionals like mortgage brokers whose work may overlap with that of advisors.¹⁶³

163. Although some progress has been made in this regard, significant work remains. For example, FINRA and the SEC only recently agreed to integrate the BrokerCheck and IAPD databases. *See* Rule Change to Amend FINRA Rule 8312 to Allow the Dissemination of IAPD Information through BrokerCheck, Exchange Act Release No. 34-88760, 85 Fed. Reg. 26,502, 26,503 (May 4, 2020). The NAIC and FINRA are also apparently working toward integrating their data on advisor misconduct. NAT'L ASS'N OF INS. COMM'RS, THE 2019 FALL NATIONAL MEETING: SYNOPSIS 13 (2019). But in light of the frequency with which FINRA brokers with histories of serious misconduct wander to state insurance regimes, and the fact that regulators are very familiar with this trend, it is surprising that these efforts are at a relatively nascent stage. Further, to the
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Such a database would benefit both regulators and consumers by significantly improving the ease and quality of monitoring advisors' work across regimes. To see why, consider the following example. Suppose an investor is contemplating hiring an insurance producer and former FINRA broker named Jonathan Smith who lives in New York. A search of insurance producers licensed in New York will yield over twenty individuals with that name—and will contain no disciplinary history for any of them. A BrokerCheck search does provide disciplinary history, but it will require the investor to sift through more than twenty-five individuals named Jonathan Smith. And unless the investor has some other basis to know that Mr. Smith was previously a FINRA broker, she would have no reason to search BrokerCheck at all.¹⁶⁴ By placing registration and misconduct records online in a centralized database, regulators, consumers, journalists, and academics can monitor advisors more easily—and reduce the benefits of crossing into a new regulatory regime for advisors with a history of misconduct.

In light of our evidence that misconduct is concentrated in a subset of advisors, we think access to each advisor's prior history is crucial. While the creation of a single, comprehensive database of financial advisors will require some coordination—and perhaps even congressional intervention—the benefits of such a resource would be significant. And those benefits will be strongest for individuals who monitor and research insurance producers, as transparency within insurance is, at present, lower than in any of our other regimes.¹⁶⁵

best of our knowledge, the data integration between the NAIC and FINRA will be available only to regulators, not consumers.

164. One might ask whether regulators or consumers would be more likely to use this resource to identify advisors likely to engage in misconduct. We acknowledge, of course, that individual investors may not conduct the research necessary to select the most qualified advisor. We note, however, that consumers' willingness to do so is endogenous to the difficulty of the task—which, as noted in the text, is unnecessarily challenging. Further, as discussed in note 103 above, there are an estimated 200,000 BASIC searches each month, and Honigsberg & Jacob, *supra* note 33, at 800, estimated 260,000 unique visitors to BrokerCheck in one month.

165. Consumer-oriented databases that contain a professional's work history, licenses, and any disciplinary infractions are common. For example, such databases exist for physicians, Certified Public Accountants (CPAs), and attorneys. See DOCINFO, <https://perma.cc/A88H-P6HP> (archived Feb. 17, 2022) (physicians); CPAVERIFY, <https://perma.cc/B3MB-EPU4> (archived Feb. 17, 2022) (CPAs); *National Lawyer Regulatory Data Bank*, A.B.A., <https://perma.cc/EVX6-B4VG> (archived Feb. 17, 2022) (attorneys). Physicians provide a helpful comparison, as evidence suggests that “jurisdictional hopping” by incompetent physicians was a founding motivation for the establishment of a national database tracking physicians. David M. Studdert, Matthew J. Spittal, Yifan Zhang, Derek S. Wilkinson, Harnam Singh & Michelle M. Mello, *Changes in Practice Among Physicians with Malpractice Claims*, 380 NEW ENG. J. MED. 1247, 1251 (2019). There is evidence that this database (the National Practitioner Data Bank) has been at least somewhat successful in improving medical care quality. See

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2. Regulatory accountability

Policymakers should also consider strengthening existing mechanisms for regulatory accountability. In particular, lawmakers should require federal regulators to track and disclose whether and how other jurisdictions make use of referrals related to advisor misconduct.

Regulators currently have informal authority to refer questions raised by firm or advisor conduct to other jurisdictions.¹⁶⁶ And referrals can lead to subsequent enforcement actions: In 2019 alone, some thirty-seven SEC enforcement actions arose from FINRA referrals.¹⁶⁷ But there is no centralized, systematic mechanism for tracking what, if anything, a sister regulator has done in response to a referral. That is especially true between federal authorities like FINRA and the SEC and state insurance regulators. Although FINRA voluntarily identifies the referrals that produced SEC enforcement actions,¹⁶⁸ we could not find any systematic information regarding how state insurance regulators approach referrals—but we are aware of numerous complaints from securities regulators who said that state insurance regulators did not act upon their referrals.

Our evidence suggests that systematic tracking of the outcomes of referrals to sister regulators can create desirable transparency related to states' varying enforcement approaches.¹⁶⁹ Further, increased regulatory focus on referrals

Teresa M. Waters & Peter P. Budetti, *The National Practitioner Data Bank: Promoting Safety and Quality*, 6 VIRTUAL MENTOR 136, 137 (2004). Notably, however, the National Practitioner Data Bank is not consumer facing; very little identifiable information is publicly available for physicians, but healthcare facilities, insurers, and some other entities are provided with—and in some instances mandated to review—additional nonpublic information. RONALD W. SCOTT, PROMOTING LEGAL AWARENESS IN PHYSICAL AND OCCUPATIONAL THERAPY 65 (1997) (noting that “employers are also required to query the data bank for information about employed or otherwise privileged licensed health care professionals on a regularly recurring basis—every 2 years”).

166. See, e.g., *Actions Resulting from Referrals to Federal and State Authorities*, *supra* note 71.

167. *Id.*

168. *See id.*

169. As we have noted, some states take enforcement actions against as few as 1 out of every 1,000 insurance producers. Schwarcz & Siegelman, *supra* note 126, at 62-63. Furthermore, state insurance regulators—who are also charged with responsibility for insurers' solvency—frequently worry that significant misconduct penalties will endanger firms' ability to pay policyholders. See U.S. GOV'T ACCOUNTABILITY OFF., GAO-05-61, FINANCIAL REGULATION: INDUSTRY CHANGES PROMPT NEED TO RECONSIDER U.S. REGULATORY STRUCTURE 4 (2004) (noting that “bank regulators generally focus on the safety and soundness of banks” and “securities and futures regulators focus on market integrity and investor protection,” but that “insurance regulators focus on the ability of insurance firms to meet their commitments to the insured”). For this and other reasons, the penalties imposed by insurance regulators for advisor misconduct tend to be lower than those imposed by securities regulators, although some states have

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across regimes is exactly the type of regulatory activity advisors who cross from one regime to another may hope to avoid, so improved coordination should reduce incentives for potential recidivists to engage in this activity. Although we suggest that all applicable regulators track and disclose their referrals, we expect this suggestion to have the most significant impact on insurance regulators, as there is currently no systematic information on referrals to insurance regulators and anecdotal evidence suggests that insurance regulators frequently fail to act upon information provided by securities regulators.

B. Institutional Design of Licensing Regimes

The prevalence of advisors who cross from one regime to another also offers lessons for the design of financial-advisory licensing regimes. In particular, our evidence suggests that lawmakers would do well to emphasize ongoing review of already-licensed advisors who have chosen to exit another financial-advisory regime. While FINRA, the SEC, state insurance regulators, and the NFA conduct ongoing review of financial advisors, the most stringent licensing barriers are typically imposed at the point of initial registration.¹⁷⁰ That choice is both typical of licensing regimes and intuitive, given that a frequently stated purpose of licensing regimes is to exclude unqualified individuals from professions that require expertise and emphasize certain ethical obligations.¹⁷¹

Our evidence indicates that more stringent ongoing review of already-licensed financial advisors is warranted not only when advisors join the regime, but also when those advisors exit another regulatory regime after misconduct. Regulators should focus on advisors with a record of misconduct,

recently introduced legislation designed to increase insurance-regulator penalty authority. *See, e.g.,* Thomas C. Lauerman, *New Enforcement Powers for NYDFS? More Sanctions and More Defendants*, CARLTON FIELDS (Apr. 13, 2020), <https://perma.cc/C3ZC-VBQ8> (noting that the most recent budget proposal presented by the governor of New York would substantially increase regulators' authority to impose penalties). We take no view as to the optimal balance among these considerations when state insurance authorities impose penalties for advisor misconduct. Instead, we argue only that improved information flow between federal and state regulators would help the latter more efficiently target advisors who pose heightened risks to consumers.

170. *See, e.g.,* Coryanne Hicks, *How to Become a Financial Advisor*, U.S. NEWS & WORLD REP. (May 27, 2021, 1:01 PM), <https://perma.cc/8JT7-R2TP> (describing the significant entry requirements for becoming a FINRA broker or '40 Act adviser, including FINRA-administered examinations).

171. *See, e.g.,* Aaron Edlin & Rebecca Haw, *Cartels by Another Name: Should Licensed Occupations Face Antitrust Scrutiny?*, 162 U. PA. L. REV. 1093, 1102-10, 1131 (2014) (documenting the increasing breadth of state-level licensure requirements and their oft-stated, if debated, regulatory purpose).

rather than those who exit the FINRA regime generally, because our analysis shows that only advisors with a history of misconduct have an increased propensity for future misconduct. Without the heightened risk associated with prior misconduct, the mere fact that a broker has exited the FINRA regime does not appear problematic—and may even facilitate continued opportunity for work for women who would otherwise find themselves out of the industry.¹⁷²

C. Insurance Regulation

Finally, given the disproportionate number of former FINRA brokers with a history of misconduct who remain insurance producers, we suggest insurance-specific reforms. While complete consideration of the insurance-regulation landscape is beyond the scope of this Article, we identify two prominent institutional characteristics in this area that warrant lawmakers' attention.

1. Limited firm-imposed discipline

Insurance producers can, and often do, operate independently of a firm, so there is limited institutional sponsorship or oversight of individual producers.¹⁷³ By contrast, a FINRA broker must be employed by a registered brokerage firm, and that firm is responsible for monitoring the conduct of its brokers.¹⁷⁴ Should a firm fail to monitor, it will be disciplined.¹⁷⁵

In this way, FINRA's oversight benefits from the work of brokerage firms, who serve as regulatory intermediaries. An increasingly extensive body of empirical evidence shows that, while the labor market is an imperfect mechanism for disciplining broker behavior and appears to discipline women more harshly than men for comparable infractions, firms nonetheless play an important role in deterring misconduct.¹⁷⁶

172. As noted above, an experimental study found that women in finance are disciplined more harshly for unexpected behavior than men (unexpected behavior in that study did not indicate any type of misconduct or poor performance). See Gupta et al., *supra* note 47, at 577-78. The ability for such women to stay in the financial-services industry after being dismissed by an employer presumably benefits those women and does not appear to harm consumers.

173. See, e.g., Brown & Minor, *supra* note 119, at 10-11.

174. *Rule 3110. Supervision*, *supra* note 44 ("Final responsibility for proper supervision shall rest with the member [firm].").

175. See Jeff Benjamin, *FINRA Fines Merrill \$300,000 for Failing to Supervise Rogue Broker*, INVESTMENTNEWS (Dec. 14, 2018), <https://perma.cc/25A4-3K3S>.

176. See, e.g., Egan et al., *supra* note 15, at 263 ("[F]irms discipline misconduct quite heavily.").

State insurance regulators, however, receive limited assistance from insurance firms as intermediaries to address producer misconduct. Because many of these individuals are self-employed, and even the misconduct of insurer-affiliated producers poses relatively limited risk to an insurance company,¹⁷⁷ the firms lack meaningful incentives to thoroughly research, monitor, and discipline producers.

Policymakers concerned about the harm caused by wayward insurance producers should consider arrangements that would give insurance firms reason to deter producer misconduct. For example, insurance companies could be required to disclose information about those who sell (and have sold) their products in a straightforward manner, including whether any former producers have been terminated after allegations of misconduct. And to the extent that insurance companies design and implement sales practices that encourage producers to engage in misconduct, lawmakers should consider whether consumer remedies should extend beyond the producer to the firm itself. As one example, FINRA fined Fifth Third Securities \$1.75 million for a series of violations related to the sale or exchange of annuities in 2009.¹⁷⁸ One of its brokers put seventy-four of his clients into expensive annuities, earning him significant commissions and winning a firm-wide sales contest that awarded both him and his supervisor a forty-two-inch flat-screen TV.¹⁷⁹ Requiring insurance firms to pay judgments arising in similar cases will give firms meaningful incentives to monitor the incentives they give producers more carefully.¹⁸⁰

177. Despite the agency relationship between an insurer and its agent, insurers are typically not legally responsible for fraud committed by an agent. *See Nat'l W. Life Ins. Co. v. Newman*, No. 02-10-00133-CV, 2011 WL 4916434, at *13 (Tex. App. 2011) (holding that, when an agent is an independent contractor and defrauds a consumer, the insurance company has no liability to the consumer unless the company directs or ratifies the fraud); *see also Williams v. Nat'l W. Life Ins. Co.*, 279 Cal. Rptr. 3d 620, 640-41 (Ct. App. 2021) (finding that, because an insurance agent was the agent of the consumer and not the insurance company, the insurance company had no duty to supervise and was not liable for the agent's severe misconduct), *vacated on other grounds and depublished by* 495 P.3d 312 (Cal. 2021).

178. Press Release, Fin. Indus. Regul. Auth., FINRA Fines Fifth Third Securities \$1.75 Million for 250 Unsuitable Variable Annuities Transactions (Apr. 14, 2009), <https://perma.cc/XW8N-V5XM>.

179. *Id.*

180. More generally, we suggest that lawmakers strengthen consumers' ability to hold insurance producers accountable. One approach would be to require that producers who operate independently carry malpractice insurance, thus ensuring that these advisors will not be judgment-proof in litigation and plausibly allowing insurance markets to serve as a disciplinary mechanism. Another option is to consider a dispute-resolution system for the insurance regime similar to the one maintained by FINRA, which relies on trained arbitrators to resolve complaints relatively quickly and inexpensively. Of course, this system is far from perfect; current objections to FINRA's

footnote continued on next page

2. Regulatory capture

We believe that the policy reforms suggested in this Article would reduce asymmetries among regulatory regimes that give advisors with a history of misconduct reason to cross from one regime to another. These reforms may appear obvious, and a reader would be forgiven for wondering why they have not already been implemented. One answer suggested by extensive prior literature is that insurance regulators have been captured by the industry that they oversee.¹⁸¹ Our own analysis is consistent with these concerns; as previously discussed, of the state legislators who sit on committees that oversee the insurance industry, almost 7.5% are currently insurance producers and almost 12% were insurance producers at one time.¹⁸²

Our final suggestions, therefore, concern structural reforms related to insurance-producer oversight. We acknowledge, of course, the long literature assessing the century-old choice to make the states the nation's principal insurance regulator.¹⁸³ But we are equally aware of the questions that have long been raised about the costs of that choice.¹⁸⁴ And we think that the costs identified in this Article—the risks to investors that are posed by advisors' freedom to cross regulatory boundaries—can be meaningfully addressed without fully revisiting that decision.

One option would be to vest a federal regulator, such as the SEC, with authority to oversee insurance products that pose investment risk akin to that presented by securities.¹⁸⁵ But we are wary of the institutional dynamics that

system include the fact that some brokers fail to pay its judgments, *see Member Firms and Associated Persons with Unpaid Customer Arbitration Awards*, FIN. INDUS. REGUL. AUTH., <https://perma.cc/7KVN-7LQK> (archived Feb. 17, 2022) (documenting this issue and providing public disclosure of “firms and individuals responsible for unpaid customer arbitration awards”), and the extensive process that allows brokers to delete items from their disclosed misconduct history, *see Honigsberg & Jacob, supra* note 33, at 801.

181. *See supra* notes 52-56 and accompanying text.

182. Consistent with concerns regarding capture, we found in an untabulated analysis that there is a positive and statistically significant correlation between state-level regulatory capture (measured as the percentage of legislators overseeing the insurance industry who are active insurance producers) and the percentage of brokers with misconduct who cross into insurance (measured as the total number of former FINRA brokers with misconduct who cross into insurance divided by the total number of former FINRA brokers with misconduct who leave their firm after misconduct, calculated at the state level).

183. *See, e.g.*, sources cited *supra* note 52.

184. *See, e.g.*, Macey & Miller, *supra* note 52, at 14 (“Among major financial institutions in the United States, only insurance firms are subject to plenary state regulation. . . . This is so even though the U.S. insurance industry is the largest in the world. . . .”).

185. We note that this approach may require congressional action to repeal Dodd–Frank’s provision reserving oversight of these products to state insurance regulators. *See footnote continued on next page*

could limit the effectiveness of this approach. For one thing, the SEC currently lacks the extensive expertise about insurance-producer practices that effective oversight would require.¹⁸⁶ For another, the SEC's limited budget is subject to congressional approval, a fact that is frequently cited as a constraint on its oversight of '40 Act advisers.¹⁸⁷

Another (and, we think, more desirable) approach would be to empower a nationwide self-regulatory organization to oversee insurance producers in the same way FINRA oversees brokers. Of course, self-regulation presents its own risk of capture, and FINRA has itself been subject to extensive criticism of its ability to oversee its industry.¹⁸⁸ But we think that FINRA's history offers meaningful lessons—and a roadmap for the structure and governance of a national insurance self-regulatory body.

For example, FINRA's bylaws require that a majority of its board be comprised of "public" governors with no formal ties to industry.¹⁸⁹ As others have explained, the independence of those governors is subject to debate, but their presence offers FINRA some credibility in its oversight of broker misconduct.¹⁹⁰ We suggest that the bylaws of any national insurance self-regulatory body correspondingly require that a significant proportion of its board be comprised of consumer representatives independent from the insurance industry. Such an arrangement would give the body meaningful credibility in its work to protect investors from advisor misconduct.

Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 989J(a), 124 Stat. 1376, 1949 (2010) (codified at 15 U.S.C. § 77c). Those who would favor that change might argue that that legislation reflects the insurance industry's lobbying prowess rather than optimal policy. *See, e.g., Indexed Annuities' Battle with SEC Comes to an End*, INSURANCENEWSNET (July 21, 2010), <https://perma.cc/DGN4-HYXP> (noting that the inclusion of this provision reflected the end of "a long and hard-fought battle with securities regulators," which was "finally won by the insurance industry").

186. As a caveat to this concern, we note that the SEC and FINRA have both previously taken the view that insurance products linked to the value of securities are within the SEC's regulatory expertise. *See* Indexed Annuities and Certain Other Insurance Contracts, Securities Act Release No. 33-8996, Exchange Act Release No. 34-59221, 74 Fed. Reg. 3137, 3138 (Jan. 16, 2009) (firmly rejecting insurance-industry objections to this rule, including that "the purchaser of an indexed annuity does not assume investment risk").

187. *See, e.g.,* Walter, *supra* note 99, at 1 (noting the SEC's resource constraints).

188. *See* DAVID R. BURTON, HERITAGE FOUND., BACKGROUNDER NO. 3181: REFORMING FINRA 5 (2017).

189. *FINRA Manual: By-Laws of the Corporation, Article VII, Sec. 4, supra* note 78.

190. Edwards, *supra* note 78, at 576; Andrew Stoltmann & Benjamin P. Edwards, *FINRA Governance Review: Public Governors Should Protect the Public Interest*, 24 PIABA BAR J. 369, 370 (2017) ("FINRA's efficacy and legitimacy as an investor protection organization requires the inclusion of Public Governors with a demonstrated commitment to investor protection.").

One objection to such an organization may be that it merely reflects federalization of insurance regulation by another name. But in the unique context of the insurance industry, we find that argument relatively unpersuasive. As we have explained in Part II, the NAIC already wields considerable regulatory authority across the insurance industry.¹⁹¹ Because the NAIC board is comprised of elected or appointed state insurance commissioners, the states play a meaningful role in the formulation of NAIC policy.¹⁹² The only question is whether the NAIC board should be expanded to include independent consumer-protection experts, and whether the NAIC's mandate should expressly encompass oversight of insurance producer misconduct. In light of the evidence presented in this Article, we think the case for those changes is strong.

We acknowledge, of course, that these limited interventions may not be sufficient to address the significant costs imposed by financial-advisor misconduct.¹⁹³ But in light of investors' increasing reliance on financial advice, our findings suggest that lawmakers should move quickly to pursue straightforward reforms targeted toward the unique problems and incentives raised by the patchwork of regulation in this area.

Conclusion

Millions of American investors now rely on financial advisors to help them make crucial decisions that shape their futures.¹⁹⁴ Advisor misconduct

191. See *supra* Part II.D.

192. See Schwarcz, *supra* note 122, at 200-05.

193. We acknowledge, for example, the important role of strengthening the fiduciary obligations that insurance producers owe to customers in deterring and remedying misconduct. For an excellent discussion of this issue, see *Agents Selling LIIS Should Be Required to Act in the Best Interest of the Consumer, Including an Obligation to Sell Only Policies That Are Suitable for the Consumer*, LIFE INS. CONSUMER ADVOC. CTR., <https://perma.cc/3H5S-YJWT> (archived Feb. 17, 2022) (arguing that it is counterintuitive to impose a higher standard of conduct for brokers than for life-insurance producers, as purchases of investment-oriented life-insurance policies are more complex than purchases of mutual funds or stocks). But we do not think that broader policy changes of this type are mutually exclusive with those proposed in the text, which are more closely related to the evidence provided in this Article. Further, given the low levels of enforcement in at least some states, it is unclear that changing the applicable standard without a concurrent change in enforcement would have the intended effect. See, e.g., Christian Leuz & Peter D. Wysocki, *The Economics of Disclosure and Financial Reporting Regulation: Evidence and Suggestions for Future Research*, 54 J. ACCT. RSCH. 525, 591-94 (2016) (summarizing the empirical literature showing that financial reporting standards alone, without applicable enforcement, have limited effect).

194. See *supra* note 7 (describing the effects of the shift from defined-benefit to defined-contribution retirement plans on American workers' need for financial advice).

imposes substantial costs on these investors. But the law governing such misconduct is scattered across a fragmented set of federal, state, and self-regulatory institutions, giving advisors with a history of wrongdoing incentives to seek out the regimes in which prior misconduct is least costly. In this Article, we have shown that such financial advisors act in a manner consistent with these incentives: They cross into relatively lax regulatory jurisdictions, where they continue to provide financial advice.

Assembling a unique dataset of some 1.2 million advisors across four distinct institutional contexts, we have identified thousands of advisors who continue to provide financial advice after exiting the brokerage industry. We show that these advisors are disproportionately men with a prior history of serious misconduct, and that these individuals are more likely to commit misconduct in the future. Critically, we show that these individuals pose the greatest threat to state insurance regimes.

Our evidence offers insights for commentators and lawmakers now debating the future regulation of financial advice. Our finding that advisors with a history of misconduct disproportionately cross into state insurance regimes is consistent with prior literature arguing that this industry is lightly regulated—and that insurance regulators are subject to capture by the industry they oversee. Our policy suggestions respond to this dynamic. Although many of our recommendations are focused on increasing transparency and regulatory accountability more generally, we expect they would have the greatest impact on insurance regulators.

We hope that our evidence will focus lawmakers on the incentives that the fragmented law governing financial advice gives to those with a history of harming investors. Addressing those incentives should be a priority for policymakers concerned with the quality of the advice that millions of Americans now rely upon to plan their financial futures.