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Jayne W. Barnard
William & Mary Law School, jwbarn@wm.edu

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Letters

Sears Incentives: A Wall Street Parallel

C. Ritchie Photography

By JAYNE W. BARNARD

THIS summer, Sears, Roebuck & Company learned that compensating its auto mechanics by awarding them bonuses for promoting high-margin services may violate the consumer protection laws, at least in some states. Chairman Edward A. Brennan quickly jettisoned Sears's compensation scheme, denying it amounted to fraud but conceding it had led to "mistakes of customers being given poor advice."

Jayne W. Barnard is a professor of law at the College of William and Mary.

As it happens, Sears's now-abandoned program looks a lot like the system by which many brokerage firms, including Sears's own, routinely compensate their stockbrokers. The result is likely to be the same — where auto mechanics had a financial stake in selling specific services, car owners often ended up paying for unneeded work; where stockbrokers have a financial stake in selling specific products, investors may find themselves getting questionable investment advice.

What kind of objective recommendation can a brokerage customer expect when a stockbroker who moves her into a firm-managed mutual fund may receive four to five times the commission she would receive if the customer put the same amount of money directly into equities? Not much different from dealing with her mechanic. The parallels are, in fact, quite striking.

In California, for example, Sears allegedly set sales targets for specific services, like wheel alignment or strut adjustments. Many brokerage firms set similar sales targets, especially for newly underwritten issues, proprietary mutual funds and profitable asset-management accounts.

In California, Sears created sales contests that pitted neighboring stores against each other in a race to sell springs and calipers. The winning employees received such prizes as tickets to California Angels games. At Dean Witter (a Sears subsidiary) recently, brokers were awarded "Love Boat" cruises, TV's and VCR's — based not upon gross commissions, but on how many new asset-management accounts they opened.

None of these practices may result in the sale of "unnecessary" investment products, in the sense that some car repairs are unnecessary. But where several investment options are available, all of which may be equally suitable for a customer, shouldn't that customer at least be entitled to know when her broker has a financial interest in promoting one product over another? Current law requires no such disclosure.

And what about the likelihood that some brokers will recommend unsuitable investments simply because they carry with them a high commission or bonus? Many brokerage firm mutual funds, for example, regularly underperform their competitors, yet brokers are rewarded handsomely for selling them to customers.

MANY brokerage firms are exploring alternatives to traditional compensation schemes. One Florida firm now offers clients the option of paying commissions or an annual flat fee. Others are re-examining the whole system that historically has encouraged active trading over long-term investment.

Whatever the eventual outcome of these efforts, investors should consider the very real impact of compensation practices on the advice brokers give them. The first step, of course, is to ask your broker just what those practices are. ■