# *The Market for Financial Adviser Misconduct*

## *by Egan, Matvos and Seru*

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*CSEF-EIEF-SITE conference on "Finance and Labor"*

*Capri – September 8-9, 2016*

# What I really liked about this paper

- The data
  - Novel database with the universe of financial advisers in the US
  - For ten years they can observe entry, exit and reemployment in the industry
- The clever use of the data and the extensive empirical analyses
  - Anatomy of misconduct and its consequences
  - Heterogeneity in firm tolerance and customer sophistication
- The practical and public policy relevance of the research question
  - First large scale and comprehensive study of financial adviser misconduct
  - Heated policy debate: from banning commissions (UK, Australia, and Canada?) to imposing fiduciary duty (US)

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# Main results

1. The anatomy of misconduct
   - On average, 7% of advisors have been or are reprimanded for misconduct in a given year
   - Past misconduct is a strong predictor of current misconduct both at the advisor and firm level
2. The consequences of misconduct
   - Reprimanded advisors are more likely to lose their job (this probability increases with the $ value of the settlement)
   - Conditional on eventually finding a job, they take shorter to find a job
   - They find less attractive jobs compared to advisors that switched from the same firm at the same time
3. In equilibrium...
   - Reprimanded advisors are less likely to separate from and more likely to be hired by firms with higher misconduct rates
   - Misconduct is more prevalent in firms with retail investors, more accounts and commission-based compensation
   - It is also more prevalent in counties with older, lower-education and higher-income people

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# Outline

- Major comments
  1. How shall we think about misconduct?
  2. How to interpret the magnitude of the effects?
  3. Are misconduct instances truly independent over time?
  4. Heterogeneity in clients: do "enforcement" play a role?
  5. What can we additionally(!) learn from the data?
- Minor quibbles
- Final remarks

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# Misconduct by financial advisors: the case of "Donald"

This report provides the information exactly as it was reported to CRD and therefore some of the specific data fields contained in the report may be blank if the information was not provided to CRD.

## Customer Dispute - Settled

This type of disclosure event involves a consumer-initiated, investment-related complaint, arbitration proceeding or civil suit containing allegations of sale practice violations against the broker that resulted in a monetary settlement to the customer.

### Disclosure 1 of 1

| | |
|---|---|
| **Reporting Source:** | Broker |
| **Employing firm when activities occurred which led to the complaint:** | CHASE INVESTMENT SERVICES CORP |
| **Allegations:** | CLIENT ALLEGES AN UNAUTHORIZED TRANSACTION REGARDING A MUTUAL FUND INVESTMENT |
| **Product Type:** | Mutual Fund(s) |
| **Alleged Damages:** | $5,340.19 |

### Customer Complaint Information

| | |
|---|---|
| **Date Complaint Received:** | 04/21/2008 |
| **Complaint Pending?** | No |
| **Status:** | Settled |
| **Status Date:** | 05/27/2008 |
| **Settlement Amount:** | $882.54 |
| **Individual Contribution Amount:** | $0.00 |

# Misconduct by financial advisors: the case of "Hillary"

The customer dispute may be pending or may have resulted in a civil judgment, arbitration award, monetary settlement, closure without action, withdrawal, dismissal, denial, or other outcome.

**Disclosure 1 of 1**

| | |
|---|---|
| **Reporting Source:** | Firm |
| **Employing firm when activities occurred which led to the complaint:** | MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED |
| **Allegations:** | THE CUSTOMERS ALLEGE UNAUTHORIZED TRADING IN MARCH, APRIL AND MAY OF 2008. |
| **Product Type:** | Other: STRUCTURED PRODUCTS |
| **Alleged Damages:** | $0.00 |
| **Is this an oral complaint?** | No |
| **Is this a written complaint?** | Yes |
| **Is this an arbitration/CFTC reparation or civil litigation?** | No |

## Customer Complaint Information

| | |
|---|---|
| **Date Complaint Received:** | 07/15/2009 |
| **Complaint Pending?** | No |
| **Status:** | Denied |
| **Status Date:** | 09/30/2009 |
| **Settlement Amount:** | |
| **Individual Contribution Amount:** | |

# I. How shall we think about *misconduct*?

- In this paper, misconduct is more closely related to being sloppy then fraudulent
  - Roughly one quarter of misconduct events are due to unsuitable recommendations
  - One third to misrepresentation or omissions
  - Only 8% is due to fraudulent behavior
- How do advisors think about it?
  - Introducing Ms.Tarr from a NYT article (9/25/2014):
    Of Ms. Tarr's 41 customer complaints, five have been settled, 11 have been withdrawn, dismissed or denied, and 25 are pending.
    At her arbitration hearing, Ms. Tarr said it was "*possible*" she might go back into the brokerage business. *"I do not feel that I did anything wrong, ever,"* she said.
    *"If the broker has one or two complaints, they probably had 40,"* the client said. *"That's the impression I get after this."*

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# II. Interpreting the magnitude: which *benchmark*?

- Financial advisers are different than physicians:
  - Feedback on investment decisions: counterfactuals easily available
  - Longer term relationship: repeated mistakes might not be forgiven
  - Larger role for network effects in filing of complaints
- If advisors try to maximize the number of clients, then misconduct could mechanically increase due to...
  - Lower customization (Foerster et al., JF forthcoming)
  - Increase in sheer mistakes
  - Increase in the likelihood of dealing with difficult customers
- Is misconduct just lower-quality and (possibly) cheaper service?
  - No stigma associated with it in the financial advisor profession
  - Advisors and firms could (and do) specialize in different quality advice
  - Low-quality/ low-cost financial advice could be an efficient equilibrium
  - Note: there are starkly different policy implications

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# II. How to interpret the *magnitude* of the effects?

- Is it all misconduct? or are we capturing the fact that:
  - firms with more clients are more likely to suffer misconduct?
  - firms and advisors could specialize in more standardized or lower-quality advice?

- Evidence that seems to support these possibilities:
  - Misconduct rate increases with "No. of Advisers(?)" (Table 6)
  - Misconduct increases with "Retail Investors", "Number of Accounts" and "Commission based" compensation (Table 11)
  - There are more "Advisers Per Capita" in lower income counties (Table A4c)
  - The consequences of misconduct are not more severe if we use more-severe measures of misconduct (Table A11b and A11c)

- Suggestions:
  - Include "Number of accounts per advisors" in each firm-level regression
  - Do we know the number of clients for each advisor?
  - Investigate measures of quality and cost of advisory services (e.g., AUM or fee-only vs. commission-based advice)

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# III. Are misconduct instances *truly independent* over time?

- The effect of prior misconduct on future misconduct dwarfs the other control variables (Table 4)
  - The probability of misconduct is higher for repeated offenders far in the future (9 year later is still 2.5 time higher)
- Nonetheless, we do not observe the exact timing of the misconduct, but the filing time
  - Misconduct is more prevalent in product such annuities and insurance that have longer investment horizons
  - The probability of repeated offenders is higher for less severe misconducts (Table A10b)
- Suggestions:
  - As a robustness check, re-run the "repeated offenders" analysis using only misconduct at prior firms
  - If available, add information on who initiated the separation as advisor-initiated separations could reduce future misconduct claims

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# IV. Is there a role for *enforcement*?

- What is the exact procedures for awarding damages or dismissing a claim?
  - Are judges involved? Are they randomly assigned? We wish...
  - Do the probability of conviction change with the demographics of the client (averages at county level)?
  - If arbitrators are more likely to side with "weaker" clients, this could generate more misconduct in counties with less sophisticated investors
  - In client-initiated claims there are stronger relations between misconduct rates and i) commission based compensation; ii) level of education; and iii) elderly people (Tables A7 and A8)

- Suggestions:
  - Regress claim success rate on county characteristics
  - Do we observe higher success rates (or settlements) for counties with elderly, less educated, and high income clients?

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# V. What can we *additionally learn* from the data?

- What explain the time-series of misconduct?
  - E.g., regress the aggregate number of misconducts on past stock market returns
  - Year fixed effects should account for systematic shocks, but it is worth to independently investigate the time-series of misconduct
  - Note: if past misconduct filings are correlated across firms, then the standard errors should be double-clustered (firm and time)
- Are good advisors rewarded?
  - What happen to the separation probability of advisors with no misconduct record?
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- Are firms penalized by the market for having higher misconduct shares?
  - Regress firm-level measures of success (e.g., AUM) on past misconduct shares
  - With and without firm fixed effects
- Are firms heterogenous in the speed of separation after misconduct?
  - Not only 0/1 decision to separate, but also the speed at which it happens (survival models)
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# Minor quibbles

- In Table 6, 10b, 12c could use Year by State fixed effects
- In Table 7c use quartiles or deciles of "$ value of settlements", to account for non linear effects of awarded damages
- In Table 10a use quartiles or deciles of "Firm Misconduct" to allow for non-linear effects
- In Table 12 could add information on financial literacy at the zip code level from FINRA (could aggregate at county level)
- Table A10b does not match with results reported in the paper, plus coefficients are not in percentage points

# To conclude

- Really enjoyed reading the paper!

- Need to better identify the actual extent of misconduct
  - What degree of misconduct is mechanically originated by having more clients?
  - Is misconduct a by-product of low-cost/ low-quality advisory services?
  - Are repeated offenders being charged for the same crime?
  - Is client segmentation driven by heterogeneity in enforcement?

- The research question investigated is of outmost importance
  - The paper implications are relevant not only for academics, but also for practitioners and policy makers
  - Need to better understand if some degree of misconduct is socially optimal

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  - Are repeated offenders being charged for the same crime?
  - Is client segmentation driven by heterogeneity in enforcement?
- The research question investigated is of outmost importance
  - The paper implications are relevant not only for academics, but also for practitioners and policy makers
  - Need to better understand if some degree of misconduct is socially optimal