When bad financial advisers happen to good people

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Over 650,000 registered financial advisers in the United States help manage over $30 trillion of investible assets and represent approximately 10% of total employment of the finance and insurance sector. However, despite their prevalence and importance, financial advisers are often perceived as dishonest and consistently rank among the least trustworthy professionals, a perception shaped by highly publicized scandals in the industry over the past decade.

In "The Market for Financial Adviser Misconduct" published in the latest issue of the *Journal of Political Economy*, authors Mark Egan, Gregor Matvos, and Amit Seru document the extent of misconduct among financial advisers and examine the labor market consequences of such misconduct.

By constructing a panel database of the roughly 1.2 million financial advisers registered in the United States from 2005-2015 containing the employment history of each adviser, the authors analyzed all customer disputes and disciplinary events and financial matters reported by the Financial Industry Regulatory Authority (FINRA) from advisers' disclosure statements during that period.

"We find that financial adviser misconduct is broader than a few heavily publicized scandals," the authors write. One in thirteen financial advisers have a misconduct-related disclosure on their record, which in sum costs the financial industry almost half a billion dollars per year.

Approximately one-quarter of advisers with misconduct records are repeat offenders who are five times more likely to engage in misconduct than the average adviser. "This result," the authors write, "implies that neither market forces nor regulators fully prevent such advisers from providing services in the future."

Some firms employ substantially more advisers with records of misconduct than others. More than one in seven financial advisers at Oppenheimer & Co., Wells Fargo Advisors Financial Network, and First Allied Securities have a record of misconduct, the authors say, compared to USAA Financial Advisors, where the ratio is roughly one in 36. Additionally, the authors find that advisers working for firms whose executives and officers have records of misconduct are more than twice as likely to engage in misconduct.

Firms are typically quite strict in disciplining employees' misconduct, so why are there so many repeat offenders? The authors find that 44% of advisers who lost their jobs after misconduct find employment in the industry within a year, often by switching to firms that employ more advisers with past misconduct records.

Rates of misconduct are 19% higher, on average, in regions with the most vulnerable populations, in counties where customers rank below national averages in terms of household incomes and college education rates.

The authors' findings suggest that the current structure of penalties or reputation concerns may not be sufficient to deter advisers from repeatedly offending. "A natural policy response aimed at lowering misconduct would be to increase market transparency and provide unsophisticated consumers access to more information," the authors write, also suggesting proposals to increase penalties for misconduct as well as to mandate a fiduciary standard for all financial advisers.

More information: Mark Egan et al, The Market for Financial Adviser Misconduct, *Journal of Political Economy* (2018). DOI: 10.1086/700735

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