Study finds ethics can be taught—in finance, at least

January 27 2020, by Andrew Gordon Sutherland

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Testing investment advisers on their knowledge of ethics can lead to better behavior, new research shows.

According to the Financial Industry Regulatory Authority, 630,000 financial representatives and investment advisers provide financial

services to half of all American households. Together, these individuals execute nearly US$40 trillion worth of transactions each year.

About 8% of these employees—or one in 12—have some form of financial misconduct on their records, according to data from BrokerCheck, an online database on the background and experience of brokers, advisers and firms. Financial misconduct ranges from simple oversights, such as the failure to inform customers of the risk of their investments, to more serious incidents, such as forging customer signatures or outright theft and fraud.

I collected the data in 2018 as part of my research on financial institutions with co-authors at Notre Dame and the London School of Economics.

Rules and ethics training in financial markets

Investor protection has been a priority for federal and state regulators since the Great Depression. For example, financial representatives seeking to sell investment advice must first become registered investment advisers, which involves passing a set of exams.

One such exam is the Series 66, which covers two broad topics: First, investment vehicle characteristics and capital market theory, or "technical material"; and, second, securities laws and prohibitions on unethical business practices, or "rules and ethics."

On average, those passing the investment adviser exam have five years of industry experience working as financial representatives.

The rules section of the Series 66 exam covers record-keeping requirements, allowable forms of adviser compensation and guidelines about when an investment adviser is permitted to take possession of

investor funds.

The ethics section focuses on an adviser's fiduciary duty to investors—that is, their obligation to act in the investor's interest rather than their own.

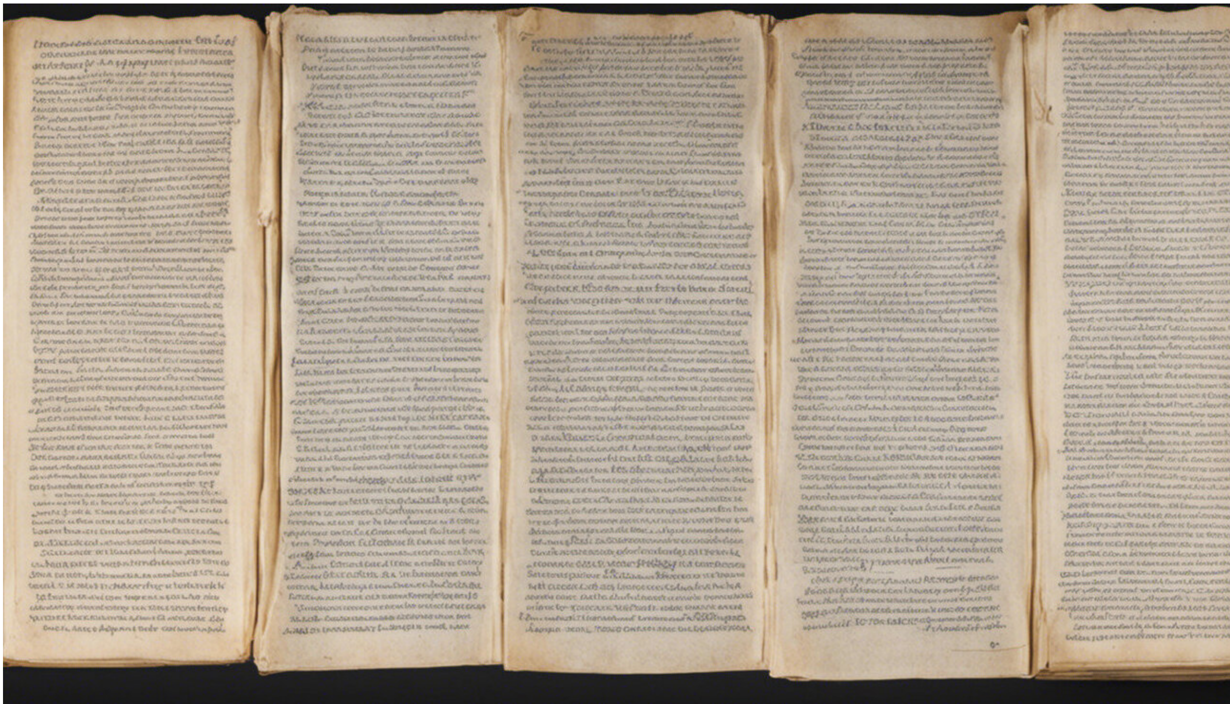
Can ethics be taught?

While such licensing requirements have existed for decades, there is a longstanding debate about the effectiveness of ethics training.

Advocates for ethics testing argue that financial crises and corporate scandals, from the 2001 Enron scandal to the Great Recession of 2007 to 2010, can often be traced back to poor conduct training and a lack of social norms.

Critics, such as the management guru Peter Drucker, question whether ethics can or even should be taught. In their view, business ethics courses were created "largely for the sake of appearances."

After all, this line of thinking goes, personal beliefs guide behavior—and such beliefs can be difficult to shape in the classroom.



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Teaching good behavior

So, can ethics be taught? According to our new research the evidence points to "yes."

We studied nearly 1.2 million financial representatives and investment advisers working at U.S. broker-dealers between 2007 and 2017, with a focus on the consequences of a 2010 change to the Series 66 exam. This is the first large-scale analysis of how rules and ethics training affects behavior in the financial sector.

Prior to 2010, 80% of the exam's questions covered rules and ethics and 20% covered technical material. In response to calls for more training in technical areas, the exam was changed in 2010 to give equal weight to

technical material and rules and ethics.

Our results, which will soon be published in the *Journal of Financial Economics*, show that investment advisers who passed the old exam with more ethics coverage were one-fourth less likely to engage in misconduct in any given year after passing.

We designed our tests to control for other factors that could relate to financial misconduct, such as investment adviser experience and firm reputation.

Exam has a 'priming effect'

The effects of the exam change vary based on industry experience and firm culture.

We found that the least experienced investment advisers are most impacted by the exam's reduction in rules and ethics-related content. The reduction in ethics content had little to no effect on those already engaging in misconduct in their prior role as financial representatives.

These results suggest the exam plays what's called a "priming" role, meaning early exposure to rules and ethics material prepares the individual to behave appropriately later.

We also studied what happens when broker-dealer firms experience ethical turmoil, such as major sanctions or a wave of misconduct.

Take Wells Fargo, for example, which faced fines and lawsuits following the 2016 revelation that it opened millions of fake accounts to generate fees and meet sales targets.

As the bank's rule-breaking began to make headlines, many investment

advisers left the firm in protest. When we looked at Wells Fargo investment advisers, we found that those who'd passed the old exam with more ethics coverage were the most likely to leave after the scandal broke.

Employees often observe the early warning signs of corporate wrongdoing, including aggressive sales practices, failure to discipline transgressions and hiring individuals with a history of misconduct. When we examined major scandals at all broker-dealer firms, another interesting pattern emerged: Departures of advisers with more rules and ethics one year indicate a greater likelihood of a scandal breaking at the firm next year.

Ethics matter

There may very well be benefits to having increased testing on technical material. Investment advisers may, for example, give their clients better recommendations—an outcome our study did not assess.

What we can say, however, is that those who were tested more rigorously on questions of ethics ended up having fewer episodes of misconduct. They are also less likely to tolerate scandals at their firms.

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