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Policy Brief

Misconduct Under the Microscope: Examining Bad Behavior by Financial Advisers

By Amit Seru

When it comes to managing their money and planning their financial futures, many Americans turn to financial advisers. As of 2010, 56 percent of all American households sought advice from a financial professional.

Today, there are over 650,000 registered financial advisers in the United States helping manage more than $30 trillion of investible assets. Their jobs account for about 10 percent of employment in the finance and insurance sector.

Despite the prevalence and importance of financial advisers, they are often perceived as dishonest and consistently rank among the least trustworthy professionals. Indeed, my research shows that more than 7 percent of financial advisers were tied to some sort of misconduct between 2005 and 2015.

While it is clear that egregious fraud does occur in the financial industry (e.g., the Madoff Ponzi scheme, the LIBOR rate-fixing scandal), the extent of misconduct in the industry as a whole has not been systematically documented. Moreover, given that every industry may have some bad apples, it is important to know how the financial industry deals with misconduct.

In particular, do regulators and industry norms operate to set the right incentives by disciplining advisers who engage in misconduct? Or do such advisers survive and thrive?

About the Author

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Documenting Dishonesty

In a *recent paper* I wrote with Mark Egan of Harvard and Gregor Matvos of the University of Texas, we attempt to provide the first large-scale study that documents the economy-wide extent of misconduct among financial advisers and financial advisory firms.

As part of our analysis, we examine the labor market consequences of misconduct and study the allocation of advisers across firms in the industry after misconduct is publicly revealed.

To study misconduct by financial advisers, we construct a panel database of all financial advisers — about 1.2 million — registered in the United States from 2005 to 2015. The Financial Industry Regulatory Authority (FINRA) requires that financial advisers formally disclose all customer disputes, disciplinary events, and financial matters. FINRA makes these records publically available on its website *https://brokercheck.finra.org/*.

We construct a measure of misconduct in the financial advisory industry that

includes all customer, civil, regulatory, firm discipline, and criminal events resolved against the adviser. In the data, we observe the misconduct records of all advisers who have worked in the industry, including those with as little as one year of experience to over 50 years of experience.

We find that financial adviser misconduct is broader than a few heavily publicized scandals. One in 13 financial advisers have a misconduct-related disclosure on their record. Misconduct is not frivolous and results in substantial costs; the median settlement paid to consumers is $40,000 and the mean is $550,000. These settlements have cost the financial industry almost half a billion dollars per year.

The incidence of misconduct varies drastically across firms. Table 1 below displays the firms with the highest rates of misconduct. Oppenheimer, First Allied Securities, and Wells Fargo Advisors Financial Network rank at the top of the list.

Roughly 20 percent of the financial advisers employed by Oppenheimer have a past record of misconduct. The estimates reported in Table 1 are conservative in the sense that they include all registered advisers, not just those that deal with clients. Among only the client-facing advisers, roughly one in three advisers at Oppenheimer have a past record of misconduct. At the other extreme, USAA Financial Advisers, which services military families, ranks among the best firms in terms of misconduct. One in 36 advisers employed by USAA Financial Advisers has a past record of misconduct.

The incidence of misconduct also varies geographically. Figure 1 and Table 2 display the geographic dispersion of misconduct. While

Table 1: Firms with the Highest Incidence of Misconduct

Rank	Firm Name (as in Broker Check)	CRD#*	Misconduct	# Advisers
1	OPPENHEIMER & CO. INC.	249	20%	2,275
2	FIRST ALLIED SECURITIES, INC.	32444	18%	1,112
3	WELLS FARGO ADVISORS FIN. NETWORK	11025	15%	1,797
4	UBS FIN. SERVICES INC.	8174	15%	12,175
5	CETERA ADVISORS LLC	10299	14%	1,432
6	SECURITIES AMERICA, INC.	10205	14%	2,546
7	NATIONAL PLANNING CORPORATION	29604	14%	1,760
8	RAYMOND JAMES & ASSOCIATES, INC.	705	14%	5,495
9	STIFEL, NICOLAUS & COMPANY, INC.	793	13%	4,008
10	JANNEY MONTGOMERY SCOTT LLC	463	13%	1,394
11	MORGAN STANLEY	149777	13%	23,618
12	SAGEPOINT FIN., INC.	133763	12%	2,063
13	WELLS FARGO ADVISORS, LLC	19616	12%	26,308
14	FSC SECURITIES CORPORATION	7461	12%	1,373
15	PURSHE KAPLAN STERLING INVESTMENTS	35747	11%	1,224
16	ROYAL ALLIANCE ASSOCIATES, INC.	23131	11%	1,975
17	RAYMOND JAMES FIN.SERVICES, INC.	6694	11%	5,176
18	WOODBURY FIN. SERVICES, INC.	421	12%	1,377
19	AMERIPRISE FIN. SERVICES, INC.	6363	10%	13,549
20	INVEST FIN. CORPORATION	12984	10%	1,425

* Central Registration Depository Number for the securities industry and its regulators

Figure 1: Geographic Dispersion Of Misconduct

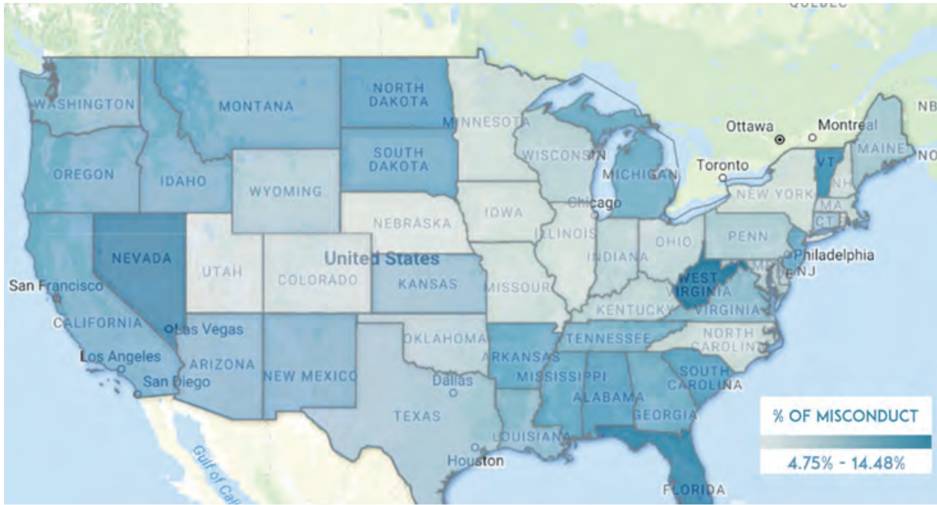


Table 2: Counties with the Highest and Lowest Incidence of Misconduct

Rank	County	Misconduct
1	Madison, NY	32%
2	Indian River, FL	19%
3	Guaynabo Municipio, PR	19%
4	Monterey, CA	18%
5	Martin, FL	18%
6	Palm Beach, FL	18%
7	Richmond, NY	18%
8	Suffolk, NY	17%
9	Bay, FL	17%
10	Lee, FL	17%

Rank	County	Misconduct
1	Franklin, PA	3%
2	Saline, KS	3%
3	Cerro Gordo, IA	3%
4	Kenton, KY	3%
5	Washington, VT	3%
6	Bronx, NY	3%
7	Rutherford, TN	3%
8	Stearns, MN	3%
9	Ottawa, MI	4%
10	Boone, MO	4%

32 percent of advisers in Madison County, N.Y., have a past record of misconduct, only 2.6 percent of advisers in Franklin, Pa., have a past record of misconduct. Misconduct is geographically concentrated. Five of the 10 highest-ranking counties are located in Florida. More generally, we find the highest rates of misconduct in areas with more elderly and less-educated populations.

Repeat Offenders

Relative to misconduct frequency, misconduct is too concentrated among advisers to be driven by random mistakes. Approximately one-third of advisers with misconduct records are repeat offenders. Past offenders are five times more likely to engage in misconduct than the average adviser, even compared with other advisers in the same firm, at the same location, at the same point in time. The large presence of repeat offenders suggests that consumers could avoid a substantial amount of misconduct by avoiding advisers with misconduct records.

The high rates of recidivism suggest that discipline is potentially lacking in the industry or by regulators, as a large number of advisers have

Figure 2: Financial Adviser Misconduct by Firm

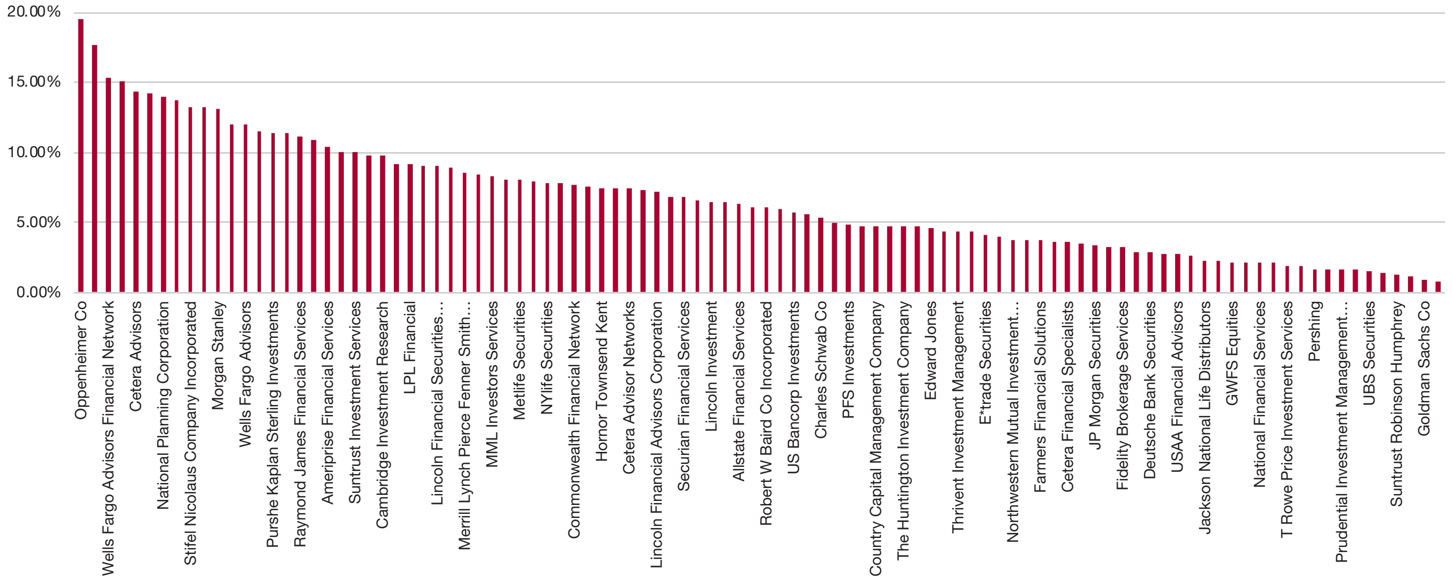
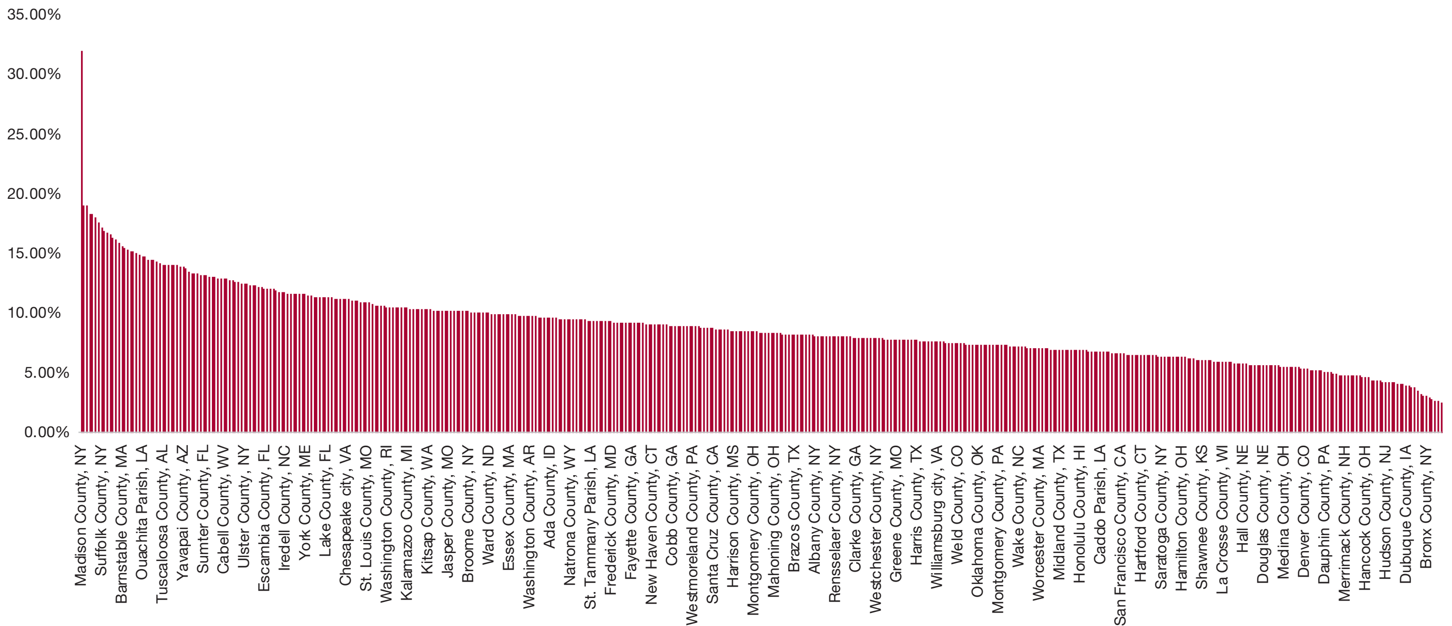


Figure 3: Financial Adviser Misconduct by County



the opportunity to re-engage in misconduct. To assess magnitudes, note that firms in the industry are relatively strict regarding disciplining misconduct. Half of advisers who engage in misconduct are separated from their firm the following year. However, the re-employment prospects of advisers with recent misconduct are relatively promising. Roughly half of those advisers who leave their firm following misconduct find new employment in the industry, typically in the same state and county. In total, 75 percent of advisers who engage in misconduct remain active in the industry in the following year.

Policy Action

Our work suggests that the current structure of penalties or reputation concerns may not be sufficient to deter advisers from engaging in misconduct. A natural policy response aimed at lowering misconduct would be to increase market transparency and provide unsophisticated consumers access to more information. It is therefore heartening to see that following the release of our study, there have been several attempts by regulators and policymakers to clamp down on “bad apples” in the industry.

We found high rates of recidivism in the financial advisory industry, which caught the attention of policymakers as well as state and federal regulators. Policymakers used the findings in our study to push for changes in the practices. Sen. Elizabeth Warren (D-Mass.) brought up issues of both levels of misconduct by advisers in the industry as well as the presence of a large number of repeat offenders during a Senate hearing in March 2016. This was followed by a letter from Warren and Sen. Tom Cotton (R-Ark.) to FINRA Chairman Richard Ketchum asking FINRA about action taken to address their concerns.

In response to this discussion, regulators are prioritizing the supervision of high-risk brokers and further examining the hiring practices of advisory firms. For example, our study prompted a recent inquiry from the Commonwealth of Massachusetts Securities Division into the hiring practices of broker-dealers. The Office of Compliance Inspections and Examinations with the SEC highlighted our research when announcing its recent intention to conduct examinations of firms that employ advisers with past records of misconduct.

Similarly, in its 2017 Annual Regulatory and Examination Priorities Letter, the Financial Industry Regulatory Authority listed the monitoring of high-risk and recidivist brokers and the firms that employ them as one of its top priorities.

Our findings on patterns of misconduct and recidivism are also part of discussions being held by policymakers as they decide what standards to suggest for advisers going forward.[1,2]

More data and details on the policy response can be found at *www.eganmatvosseru.com*.

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1 Examples include Senator Elizabeth Warren’s remarks on the Senate Banking subcommittee hearing on *Regulatory Reforms to Improve Equity Market Structure*, Senators Elizabeth Warren and Tom Cotton’s *letter to FINRA Chairman Richard Ketchum*, *The National Exam Program* by the Office of Compliance Inspections and Examinations and the Securities and Exchange Commission, and the Massachusetts Securities Division’s *Sweep of Select Broker-Dealers that Hire Bad Agents*. For more details see *www.eganmatvosseru.com*.

2 Our study has also received much attention in the popular media including The New York Times, *The Wall Street Journal*, *The Economist*, *The Financial Times*, and *Bloomberg*. For more details see *www.eganmatvosseru.com*.

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