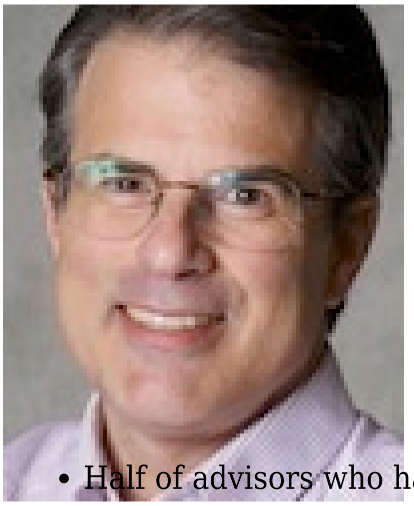
Bad Apples in the Brokerage Business

By Kerry Pechter   *Thu, Mar 10, 2016*

A new study from the University of Chicago asserts that "some [brokerage] firms 'specialize' in misconduct and cater to unsophisticated consumers." Overall, 7.28% of registered brokers and investment advisors have committed misconduct, the report said.



As the brokerage world awaits a regulatory coup de grace from the Department of Labor—in the form of the "fiduciary rule"—three academics claim to have found that 7.28% of the 650,000 registered reps and Series 6 investment advisors affiliated with brokerages in the U.S. have some smirch of "misconduct" on their work records.

Titled, "The Market for Financial Advisor Misconduct," the report makes several serious charges:

- Half of advisors who have committed misconduct keep their jobs
- Many (44%) are able to get new securities jobs within a year
- Some firms tolerate misconduct by advisors more than others
- Firms and advisors with records of misconduct tend to cluster near wealthy older people in Sunbelt states and in counties with low numbers of college graduates
- Advisors who have committed misconduct in the past are five times more likely than average to be repeat offenders
- Brokers who work with retail clients are more likely to have a history of misconduct than those who work with sophisticated institutional clients.

The study isn't as much a man-bites-dog story as it might first appear. It's an open secret that many people who describe themselves as "financial advisors" are in reality highly incentivized sales personnel in the famously cut-throat and arguably under-regulated securities industry. Given the public's documented mistrust of the financial services industry, a report saying that 92% of brokers have clean records might have been more surprising.

But the report is a kind of wake-up call—especially in its assertion that "some firms 'specialize' in misconduct and cater to unsophisticated consumers." The authors, Gregor Matvos and Amit Seru of the Booth School of Business at the University of Chicago and Mark Egan of the Carlson School of Business at the University of Minnesota, claim this to be the first large-scale study of misconduct among advisors and advisory firms.

"Our intention was to put out some facts," Matvos told RIJ in an interview. "We thought this was an interesting issue on which people held strong beliefs but where systematic research was lacking."

The researchers looked at data on 1.2 million people who worked as advisors in the U.S. from 2005 to 2015. Data on misconduct came from FINRA's BrokerCheck database. "We document substantial misconduct among U.S. financial advisers. More than 12% of financial advisers have a disclosure [of a client dispute] on their records and approximately 7% have been disciplined for misconduct and/or fraud," the paper said.

Brokerage Firms With Highest and Lowest Incidences of Advisor Misconduct

Company	Pct.	Adv.
Highest Incidence		
Oppenheimer	19.60	2,275
First Allied Securities	17.72	1,112
Wells Fargo Advisors FN	15.30	1,797
UBS Fin. Services	15.14	12,175
Cetara	14.39	1,432
Securities America	14.30	2,546
National Planning Corp.	14.03	1,760
Raymond James	13.74	5,495
Stifel, Nicolaus	13.27	4,008
Janney M'tgomery Scott	13.27	1,394
Lowest Incidence		
Morgan Stanley	.79	3,807
Goldman Sachs	.88	7,380
BNP Paribas Securities	1.17	1,109
SunTrust Robinson Humphries	1.25	1,040
BlackRock Investments	1.39	1,442
UBS Securities	1.51	1,785
Jeffries	1.67	1,676
Prudential Inv. Mgmt.	1.70	1,234
Wells Fargo Securities	1.70	2,876
Pershing	1.72	1,049

Source: "The Market for Financial Advisor Misconduct," NBER Working Paper 22050, Feb. 2016.

One in four disputes listed unsuitable investments as an underlying cause of the dispute. "Misrepresentations or omissions of key facts" together accounted for a third of disputes. About 7% of allegations fell under the category of fraudulent behavior, which carries more severe penalties. The most popular investments (insurance, annuities stocks and mutual funds) were most commonly engaged in disputes. Most annuity disputes were related to variable annuities rather than fixed rate annuities.

One practical finding in the report was that investors can find out on FINRA’s website if an advisor has been involved in a dispute, and should assume that the risk of future misconduct is relatively high.

“Financial advisors with prior misconduct are five times as likely to engage in misconduct than the average financial advisor. More desirable or popular firms have lower rates of misconduct on average,” the report said.

Financial advisors who held a Series 66 or 65 exam were 50% more likely than average to be disciplined for misconduct than the average financial advisor—apparently because brokers were more transaction-focused or worked mainly with institutional clients or both.

Firms that charge hourly or based on assets under management were more likely to engage in new misconduct and have a higher share of advisors who have engaged in misconduct in the past.

“We found that some firms are very good at getting rid of people [who commit misconduct], but other firms are hiring them and neutralizing the cleansing effect,” Matvos told *RIJ*.

About half of advisors who are found guilty of misconduct lose their jobs afterwards, and about 44% of those who lose their jobs find new jobs in the industry within a year, albeit at annual compensation that is on average $15,000 lower and at less reputable or prestigious firms, the report said. The median settlement was for $40,000 and damages in a quarter of cases exceeded $120,000.

The report compares financial advisors unfavorably with medical doctors. Though more than half of doctors are sued for malpractice during their careers, there’s apparently less indication of patterns of abuse or tolerance for repeat-offenders.

But that’s an unfair comparison. On the one hand, both doctors and brokers are in a position of trust, and usually have big information advantages over their clients. But doctors go through rigorous post-graduate training and take the Hippocratic oath to “first, do no harm.”

Brokers aren’t necessarily even college graduates, and they’re held to a suitability standard, which bans abuse but allows them to put their interests or their firms’ interests ahead of the clients’. There’s a relatively low barrier to entry to the field; it makes the incidence of misconduct less surprising.

If the authors of the study had looked only at registered investment advisors or Certified Financial Advisors or fee-only advisors, all or most of whom have to meet a “fiduciary” standard of conduct that requires them to put their clients’ interest ahead of their own, it might have found a much lower rate of misconduct. Alternately, if you compared brokerage advisors with sales personnel in general, they might compare favorably.

The “misconduct” that the report describes sounds suspiciously like the behavior of aggressive salespeople. It wouldn’t be surprising if disgraced brokers get rehired for the same aggressiveness they were fired for.