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THE MARKET FOR FINANCIAL ADVISER MISCONDUCT

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### **ABSTRACT**

We construct a novel database containing the universe of financial advisers in the United States from 2005 to 2015, representing approximately 10% of employment of the finance and insurance sector. We provide the first large-scale study that documents the economy-wide extent of misconduct among financial advisers and the associated labor market consequences of misconduct. Seven percent of advisers have misconduct records, and this share reaches more than 15% at some of the largest advisory firms. Roughly one third of advisers with misconduct are repeat offenders. Prior offenders are five times as likely to engage in new misconduct as the average financial adviser. Firms discipline misconduct: approximately half of financial advisers lose their jobs after misconduct. The labor market partially undoes firm-level discipline by rehiring such advisers. Firms that hire these advisers also have higher rates of prior misconduct themselves, suggesting “matching on misconduct.” These firms are less desirable and offer lower compensation. We argue that heterogeneity in consumer sophistication could explain the prevalence and persistence of misconduct at such firms. Misconduct is concentrated at firms with retail customers and in counties with low education, elderly populations, and high incomes. Our findings are consistent with some firms “specializing” in misconduct and catering to unsophisticated consumers, while others use their clean reputation to attract sophisticated consumers.

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# 1 Introduction

American households rely on financial advisers for financial planning and transaction services. 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 (NAICS 52; Coen 2015).<sup>1</sup> As of 2010, 56% of all American households sought advice from a financial professional (Survey of Consumer Finances, 2010). Despite their prevalence and importance, financial advisers are often perceived as dishonest and consistently rank among the least trustworthy professionals (e.g., Edelman Trust Barometer 2015, Prior 2015, Zingales 2015). This perception has been largely shaped by highly publicized scandals that have rocked the industry over the past decade. While it is clear that egregious fraud does occur in the financial industry, 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 this paper we attempt to provide the first large-scale study that documents the economy-wide extent of misconduct among financial advisers and financial advisory firms. We examine the labor market consequences of misconduct for financial advisers and study adviser allocation across firms following misconduct. Lastly, we provide an explanation that is consistent with the facts we document.

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, representing approximately 10% of total employment of the finance and insurance sector. The data set contains the employment history of each adviser. We observe all customer disputes, disciplinary events, and financial matters reported by FINRA from advisers' disclosure statements during that period. The disciplinary events include civil, criminal, and regulatory events, and disclosed investigations, which FINRA classifies into twenty-three disclosure categories. Because disclosures are not always indicative of wrongdoing, we conservatively isolate six of the twenty-three categories as misconduct including regulatory offenses, criminal offenses, and customer disputes that were resolved in favor of the customer.

In the first part of the paper, we document the extent of financial misconduct among financial advisers and financial advisory firms. We find that financial adviser misconduct is broader than a few heavily publicized scandals. One in thirteen financial advisers have a misconduct-related disclosure on their record. Adviser misconduct 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.<sup>2</sup>

Relative to misconduct frequency, misconduct is too concentrated among advisers to be driven by random

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<sup>1</sup>We will use the term "financial adviser" throughout the paper to refer to representatives registered with the Financial Industry Regulatory Authority (FINRA). FINRA is the largest self-regulatory organization that is authorized by Congress with protecting investors in the U.S. Our definition, similar to FINRA's, includes all brokers and the set of investment advisers on BrokerCheck who are also registered as brokers. FINRA reports that the term "financial advisor is a generic term that typically refers to a broker (or to use the technical term, a registered representative)". [<http://www.finra.org/investors/brokers> and <http://www.finra.org/investors/investment-advisers>].

<sup>2</sup>We calculate the total cost to the industry as the sum of all settlements granted per year in our data.

mistakes. Approximately one-quarter 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, and 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. Furthermore, this result implies that neither market forces nor regulators fully prevent such advisers from providing services in the future.

We find large differences in misconduct across financial advisory firms. 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. At USAA Financial Advisors on the other hand, the ratio is roughly one in thirty-six. We find that advisers working for firms whose executives and officers have records of misconduct are more than twice as likely to engage in misconduct. Differences across firms are persistent and survive after conditioning on a firm's business model, such as whether advisers are client facing or not, firm structure, and regulatory supervision. Therefore, firms and advisers with clean records coexist with firms and advisers that persistently engage in misconduct.

After documenting basic differences in the prevalence of misconduct across financial advisers and financial advisory firms, we explore the labor market consequences of financial adviser misconduct. What punishment should we expect for misconduct? One benchmark is extreme punishment of misconduct at the firm and industry levels. Firms, wanting to protect their reputation for honest dealing, would fire advisers who engage in misconduct. Other firms would have the same reputation concerns and would not hire such advisers. Then advisers would be purged from the industry immediately following misconduct, and only advisers with clean records would survive in equilibrium. The alternative benchmark is extreme tolerance of misconduct. Firms would not fire advisers who engage in misconduct, and employees with misconduct would not be penalized when looking for new jobs. Of course, we expect reality to fall somewhere between these benchmarks. We use the panel structure of our data to investigate how firms punish misconduct and how advisers' misconduct records affect their employment dynamics. We then show that differences between firms play an important role in how the market for misconduct operates.

The substantial presence of repeat offenders in the pool of financial advisers implies that misconduct does not automatically result in removal of an adviser from the industry. Therefore, it is perhaps surprising that firms are quite strict in disciplining employees' misconduct. Almost half of financial advisers who engage in misconduct in a given year do not keep their jobs into the subsequent year. The job turnover rate among advisers with recent misconduct is roughly 31 percentage points (pp) higher than the job turnover rate among advisers without recent misconduct (19%). We confirm our results do not arise because of differences between firms, regulations, customer bases, or labor market conditions by comparing employees from the same firm, in the same county, and at the same time. Firms do not discipline randomly, but seem to deliberately assess the severity of misconduct before making a termination decision. We find that larger monetary damages

from misconduct result in a higher job separation probability.

If individual firms are strict in disciplining bad employees, why are there so many repeat offenders in the population of financial advisers? We find that 44% of advisers who lost their jobs after misconduct find employment in the industry within a year. The hiring of employees with misconduct records undoes some of the discipline practiced by firms. However, reemployment does not imply that discipline related to misconduct is completely absent at the industry level. Even accounting for reemployment, advisers experience elevated probabilities of industry exit following misconduct. They experience longer gaps between employment spells in the industry. Conditional on finding new employment, they move to firms with lower compensation and that are less desirable, as measured by “followers to a firm” on a social networking website for professionals. Again, we find these patterns even when we compare advisers with misconduct to other employees from the same firm, at the same location, and at the same point in time.

In the last part of the paper we provide a potential interpretation that is consistent with these facts. Why are some firms willing to hire advisers who were fired following misconduct? If firms had identical tolerance toward misconduct, such rehiring would not take place. We find that advisers with misconduct switch to firms that employ more advisers with past misconduct records. These results suggest that there is matching between advisers and firms on the dimension of misconduct. We find further evidence of such matching when examining the composition of new hires across firms. The firms that hire more advisers with misconduct records are also less likely to fire advisers for new misconduct. This inclination should make these firms especially attractive to advisers who might engage in future misconduct. Thus the matching between firms and advisers on misconduct partially undermines the disciplining mechanism in the industry, lessening the punishment for misconduct in the market for financial advisers.

The disciplinary records of financial advisers are public record. Therefore, one might ask why competition among advisers and reputation does not drive out bad advisers and firms. One potential reason is that some customers may not be very sophisticated.<sup>3</sup> Such customers do not know either that such disclosures even exist, or how to interpret them. If there are differences in consumer sophistication, then the market can be segmented. Some firms “specialize” in misconduct and attract unsophisticated customers, and others cater to more sophisticated customers and specialize in honesty, in the spirit of Stahl (1989) and Carlin (2009).

To shed more light on this mechanism, we collect additional data on financial advisory firms’ customer base from the Securities and Exchange Commission (SEC) Form ADV. Retail investors, who are not high net worth individuals, are generally considered less sophisticated.<sup>4</sup> We find that misconduct is more common among firms that advise retail investors. The geographic distribution of advisory firms is also consistent with market segmentation along the lines of investor sophistication. We document substantial geographic differences in financial misconduct. In many counties in Florida and California, roughly one in five financial

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<sup>3</sup>For other examples of work on consumer sophistication and household financial decisions, see, for example, Gabaix and Laibson 2006; Hastings and Tejada-Ashton 2008; Carlin and Manso 2011; Lusardi and Mitchell, 2011; Duarte and Hastings 2012.

<sup>4</sup>This definition is also used for regulatory purposes. The Investment Company Act of 1940 considers high net worth individuals to be more sophisticated than smaller retail investors, allowing them substantially more latitude in their investments.

advisers have engaged in misconduct in the past. Misconduct is more common in wealthy, elderly, and less educated counties. The latter two categories have generally been associated with low levels of financial sophistication (Gurun et al. 2015). Rates of misconduct are 19% higher, on average, in regions with the most vulnerable populations; those counties that rank below the national averages in terms of household incomes and college education rates.<sup>5</sup> Misconduct among these vulnerable populations may be particularly costly, as these populations likely have the highest marginal propensity to consume. These results, while not conclusive, suggest that misconduct may be targeted at customers who are potentially less financially sophisticated.

We conduct several tests to ensure the patterns we document are robust. First, we examine alternative classifications when constructing our measures of misconduct. In particular, the facts we uncover are qualitatively similar when we use a “severe” measure of misconduct. To measure “severe” misconduct, we restrict our definition of misconduct disclosures to include only disclosures that are definitive cases of adviser dishonesty, such as fraud and unauthorized activity. Moreover, we also experiment with alternative specifications and find similar results. When studying recidivism and labor market outcomes of advisers following misconduct, we compare financial advisers within a firm, in the same county, and in the same year. Therefore, the conclusions from this analysis are not the result of firm differences, including different business models. In our baseline labor market analysis, the “control” group comprises advisers who were employed at the same firm, in the same location, at the same time, and who also switched jobs. One might be concerned that this “control” group selects on advisers who switch jobs and therefore does not accurately represent the average adviser at the firm. To address this concern, we examine outcomes of advisers from dissolved firms. In such firms, all advisers, independent of past misconduct, are forced to find new employment. The results mirror those from our baseline specification qualitatively as well as quantitatively. Finally, we find our facts for financial advisers registered with FINRA, those registered as investment advisers with the SEC, and those dually registered with both the SEC and FINRA. Unlike those financial advisers solely registered with FINRA, advisers registered as investment advisers are held to a fiduciary standard. Although other research, such as Egan (2016), has shown that holding all financial advisers to a fiduciary standard could improve investment outcomes, doing so may not be adequate in dealing with misconduct.

Our paper relates to the literature on fraud and misconduct in finance. The economics literature on misconduct dates back to the seminal work of Becker (1968) on crime and punishment. More recently, there has been a growing literature on misconduct among financial advisers. Qureshi and Sokobin (2015) examine the characteristics of those financial advisers who cause investor harm and the predictability of investor harm. Dimmock et al. (2015) study the transmission of brokerage fraud through peer (career) networks and find that fraud is contagious across firms. This conclusion is consistent with our finding that the incidence of fraud varies systematically across firms.<sup>6</sup> Previous research has documented misconduct in other industries.

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<sup>5</sup>Over the period 2009-2013, the average incidence of misconduct in counties below both the median level of household income and college education rates was 1.07% per annum. Conversely, the average incidence of misconduct in all other counties above both the median level of household income and college education rates was 0.90% per annum.

<sup>6</sup>There is also a related literature which has argued that financial advisers steer clients towards worse financial products

For example, Piskorski et al. (2013) and Griffin and Maturana (2014) document evidence of misconduct in the mortgage industry, and numerous papers have documented similar evidence of corporate fraud including: Povel et al. (2007), Dyck et al. (2010; 2014), Wang et al. (2010), Khanna et al. (2015), and Parsons et al. (2015).

Our paper also relates to the broad literature on how labor markets punish corporate misconduct (Fama 1980, Fama and Jensen 1983). Previous work shows that directors lose board seats if their firms restate their earnings (Srinivasan, 2005), are involved in class action lawsuits (Helland 2006), engage in financial fraud (Fich and Shivdasani 2007), or are involved in proxy contests (Fos and Tsoutsoura 2014). CEOs face similar career punishments if their firms engage in financial misconduct (e.g., Agrawal, Jaffe, and Karpoff 1999). For example, Karpoff et al. (2008) find that CEOs who lose their jobs following regulatory enforcement actions also do worse in the labor market in the future.

A recent literature documents the importance of financial advisers and other intermediaries in shaping the investment decisions of households.<sup>7</sup> Trust and consumer sophistication are believed to be critically important in these markets (see, Gennaioli, Shleifer and Vishny 2015; Guiso, Sapienza, and Zingales 2008; and Garleanu and Pedersen 2016). We build on this literature by documenting the roles of consumer sophistication and misconduct, both of which have important implications for trust (Gurun et al. 2017). Our findings suggest that a natural policy response to lowering misconduct is an increase in market transparency and in policies targeting unsophisticated consumers. In doing so, our paper connects to the literature that has evaluated various policy responses in regulating consumer financial products (Campbell 2006; Campbell et al. 2011; Agarwal et al. 2009 and Agarwal et al. 2014).

## 2 Data and Descriptive Statistics

We construct a novel data set containing all financial advisers in the United States from 2005 to 2015. We collect the data from Financial Industry Regulatory Authority’s (FINRA) BrokerCheck database. FINRA is the largest self-regulatory organization tasked by Congress with ensuring that the securities industry operates fairly and honestly. The data includes all financial advisers registered with FINRA. Throughout the paper we refer to a financial adviser as any individual who is registered with FINRA but are careful to make distinctions about additional registrations or qualifications a financial adviser may hold, such as being a registered investment adviser or a general securities principal. Brokers (or stockbrokers) are registered with FINRA and the SEC and are defined in the Securities and Exchange Act 1934 as “any person engaged in the business of effecting transactions in securities for the account of other.” An investment adviser provides financial advice rather than transaction services. Although both are often considered “financial advisers,”

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without engaging in misconduct (e.g., Bergstresser, Chalmers, and Tufano, 2009; Mullainathan, Noeth, and Schoar, 2012; Christoffersen, Evans and Musto 2013; Chalmers and Reuter, 2015; Egan 2016).

<sup>7</sup>For example, Anagol, Cole, and Sarkar (2013) in the insurance industry; Gurun, Matvos and Seru (2015) in the mortgage industry; Hastings, Hortaçsu and Syverson (2015) in the fund industry; and Barwick, Pathak and Wong (2015) in the real estate industry.

brokers and investment advisers differ in terms of their registration, duties, and legal requirements. Two of the main differences are that brokers are regulated by FINRA and are held to a suitability standard while investment advisers are regulated by the SEC and are held to a fiduciary standard. Roughly 84% of active SEC registered investment advisers are also dually registered with FINRA as brokers. Thus, the BrokerCheck data includes all brokers and the vast majority of investment advisers. Throughout the paper, we will use terminology consistent with FINRA and refer to both investment advisers and brokers as “financial advisers.” We present results for the two groups separately in Section 6.

For each adviser, the data set includes the adviser’s employment history, qualifications, and disclosure information. In total, the data set contains 1.2 million financial advisers and includes roughly 8 million adviser year observations over the period. We also collect information on the universe of financial advisory firms from the BrokerCheck database. We supplement our FINRA data set with additional firm-level data. For a small subset of the firms, we observe firm assets, revenues, and compensation structure data from a private industry survey. We acquire data on the popularity of a firm using CVs in the database of a leading social networking website for professionals. We hand-match the names of the firms to the FINRA data. We also utilize county-level data from the 2010 Census and the 2010-2013 American Community Survey to obtain county-level employment and demographic information. Lastly, we collect data on firms’ customer bases and fee structures from Form ADV filings, which investment advisory firms file with the SEC. We match this data to BrokerCheck data exactly, using the unique numerical identifier, CRD#.

## 2.1 Financial Adviser-Level Summary Statistics

The data set contains a monthly panel of all registered advisers from 2005 to 2015. This panel includes 644,277 currently registered advisers and 638,528 previously registered advisers who have since left the industry. For each of the 1.2 million advisers in the data set, we observe the following information:

- The adviser’s registrations, licenses, and industry exams he or she has passed.
- The adviser’s employment history in the financial services industry. For many advisers we observe employment history dating back substantially further than the past ten years.
- Any disclosures filed, including information about customer disputes, whether these are successful or not, disciplinary events, and other financial matters (i.e., personal bankruptcy).

Table 1a displays the average characteristics of financial advisers. The average adviser in our sample has 11 years experience, defined as the number of years since the adviser passed her first qualification exam. Approximately half of active advisers are registered as both brokers and investment advisers. The advisers in our data set account for roughly 0.50% of all employed individuals in the United States and approximately 10% of employment of the Finance and Insurance sector (NAICS 52). Central to our purposes, over 12% of

active financial advisers' records contain disclosures.<sup>8</sup> A disclosure indicates any sort of dispute, disciplinary action, or other financial matters concerning the adviser. Not all disclosures are indicative of fraud or wrongdoing. We construct our measure of misconduct-related disclosures based on FINRA's disclosure classifications in Section 3. FINRA classifies disclosures into 23 categories as described in the Appendix.

Table 1a reports the share of advisers who have passed any of the six most popular qualification exams taken by investment professionals.<sup>9</sup> Most states require that a registered financial representative, at a minimum, pass the Series 63 exam, which covers state security regulations. The Series 7 exam is a general securities exam that is required by any individual who wishes to sell and trade any type of general securities products. The Series 65 and 66 examinations qualify individuals to operate as investment advisers. Although not required by all states, most investment advisers hold either a 65 or 66 examination. A Series 6 exam qualifies an investment adviser to sell open-end mutual funds and variable annuities. Finally, the Series 24 exam qualifies an individual to operate in an officer or supervisory capacity at general securities firms. While about one-fourth of active advisers operate in only one state, 10% are registered to operate in all fifty states.

In the Online Appendix we examine the distribution of financial advisers across the US and across firms. Not surprisingly, given the nature and size of the regions, the New York, Los Angeles, and Chicago metropolitan areas rank among the highest in terms of the number of financial advisers. The number of advisers per capita tends to be greater in more educated, more populous areas, and actually slightly less wealthy areas.

## 2.2 Firm-Level Summary Statistics

From our adviser level data set, we observe the full adviser and branch history for the universe of financial advisory firms over the period 2005-2015. The FINRA BrokerCheck database also contains summary details for the set active firms (as of 2015) the advisers represent. Active firms are identified by the corresponding CRD identification number. Firms with distinct CRD numbers can share a same parent company. For instance, Wells Fargo operates several financial services businesses under separate numbers. In particular, Wells Fargo has several operations such as Wells Fargo Advisors Financial Network (CRD# 11025), Wells Fargo Advisors (CRD# 19616), and Wells Fargo Securities (CRD# 126292). The different CRD numbers reflect different operations and business lines. For example, Wells Fargo Advisors Financial Network is an arm of Wells Fargo comprised of independent advisers that are affiliated but not technically employed by Wells Fargo (<https://www.wfafinet.com/>). Wells Fargo Advisors reflects Wells Fargo's in-house network of advisers. Similarly, Morgan Stanley has several operations such as Morgan Stanley & Co. (CRD# 8209) and Morgan Stanley (CRD# 149777).<sup>10</sup> The active advisers in our data work for one of over 4,178 different

<sup>8</sup>As indicated by Ed Beeson at Law360.com, our share of advisers with disclosures over the 2005 to 2015 period, 12.7%, closely matches that of FINRA, 12.6%, estimated for currently registered advisers in March of 2016.

<sup>9</sup>FINRA provides detailed descriptions of each qualification exam on their website [<http://www.finra.org/industry/qualification-exams?bc=1>].

<sup>10</sup>We decided not to merge firms with different CRD#s for several reasons. First, any merging would be arbitrary and would reflect our choice rather than the actual firm choices in regulatory filing. Second, the different CRD numbers frequently reflect different operations and business lines, and we are interested in assessing how various business lines correlate with misconduct.

firms. Figure 1 displays the distribution of these firms. The average firm employs just over 155 advisers. Firms range from one employee to over 30,000 advisers. For each active firm we observe the firm’s business operations, including its size, number of businesses/operations, and referral arrangements as of 2015. We also observe registration information, such as the number of states the firm is currently registered in and the number of regulatory memberships. Finally, we observe the type of incorporation for active firms. We use several of these firm characteristics in our analysis.

Table 1b displays the average firm characteristics. Roughly one in four firms is registered as an investment advisory firm. Recall that just under half of financial advisers are also registered as investment advisers. Roughly half of financial advisory firms are affiliated with a financial or investment institution. For example, Wells Fargo Advisers is affiliated with Wells Fargo Bank. Lastly, the average firm operates in roughly six distinct types of business operations. Such operations could include trading various types of securities (equities, corporate bonds, municipal bonds), underwriting corporate securities, retailing mutual funds, or soliciting time deposits.

We use additional firm level data from the SEC’s Form ADV filings. The SEC requires investment advisory firms to disclose information on the firm’s clientele and business practices in the Form ADV. We match the firms in our FINRA data to the SEC form ADV filings based on the firm’s CRD#. Since not all financial advisory/brokerage firms file Form ADV, we only observe the Form ADV filings for 405 unique firms in our data set over the period 2011-2014. The second panel of Table 1b displays the average characteristics of these firms. The vast majority (86%) of firms report having retail clients. Most firms report charging based on assets under management, a fixed fee, and/or an hourly fee.

We also supplement our data set with additional information from a private industry survey and from a popular social networking site. The industry survey provides details on the assets, revenue, and average adviser payout/salary for a subset of the firms in our FINRA data as of 2014. We are able to manually match 75 of the firms in our FINRA data set to the private industry survey based on the firm’s name. Although we observe survey information for a subset of the firms, these firms are generally the largest such that we observe average payout estimates for 20% of advisers. The average firm operates 23bn in assets and generates 261mm in revenue. Lastly, we measure the popularity of each firm as the number of individuals who follow a firm on a popular social media website as of May 2015. We are able to manually match 40% of the firms in our FINRA data set to the social media website based on the firm name. The average firm has 2,365 followers.

### 3 Misconduct

In this section we document the extent of misconduct in the financial advisory industry. We first construct our measure of misconduct based on the disclosures reported to FINRA. Next, we examine the characteristics of financial advisers that are disciplined for misconduct. We then document the high incidence of repeat

offenders. Lastly, we examine how misconduct varies across financial advisory firms.

### 3.1 Classifying Misconduct

FINRA requires that “all individuals registered to sell securities or provide investment advice are required to disclose customer complaints and arbitrations, regulatory actions, employment terminations, bankruptcy filings, and criminal or judicial proceedings.” We observe the full set of such disclosures for each financial adviser across the time period of our data.

As noted earlier, disclosures are categorized into twenty-three categories ranging from criminal offenses to customer disputes. Table 2 displays the share of financial advisers that have disclosures in each category. Each type of disclosure is described in the Appendix. As we also noted – given that the nature of disclosure varies substantially and is not always indicative of wrongdoing – we restrict our classification of disclosures indicating misconduct to include only six of the twenty-three categories: Customer Dispute-Settled, Regulatory-Final, Employment Separation After Allegations, Customer Dispute - Award/Judgment, Criminal - Final Disposition, Civil-Final. We classify the other seventeen categories as “Other Disclosures.” By using FINRA’s disclosure categories, we take a relatively agnostic approach to classifying misconduct. Our definition of misconduct resolves around criminal, regulatory, internal investigations, and customer events that were resolved against the adviser.

A few comments on this classification, which we believe is conservative in defining misconduct, are worth mentioning. First, we do not classify categories such as “Financial-Final” as misconduct. Such categories, for instance, could pertain to the financial adviser’s personal bankruptcy. Although a consumer may have reason to be leery of a financial adviser that frequently declares bankruptcy, it is not necessarily indicative of misconduct. Second, a consumer dispute that was resolved in favor of the financial adviser, categorized as “Customer Dispute - Denied,” is not included in our measure of misconduct. Nor are claims, which were withdrawn. Third, we also exclude categories from our classification of misconduct in which the fault of the adviser is still to be determined, such as those disclosures designated as “Customer Dispute - Pending.”

Even though we classify “Other Disclosures” separately from misconduct, these categories could also be indicative of misconduct. For example, statistically, we find that an adviser engaged in a consumer dispute that is “pending” is more likely to have engaged in misconduct than an adviser who has not been involved in any dispute. However, because the basic description in these categories is less clearly indicative of misconduct, we are conservative and do not classify these categories as misconduct. We demonstrate the robustness of our classification scheme extensively when we revisit this issue in Section 6.

We measure misconduct in the economy in two ways. The first approach measures the flow of new misconduct. We measure the flow of misconduct as a binary variable that captures whether or not a financial adviser received a misconduct-related disclosure in a given year. We date each disclosure with the date at which the claim was initiated, reflecting reporting in BrokerCheck. Therefore, under our measure of misconduct, advisers with several records of misconduct initiated in a given year are recorded as having

one instance of misconduct. This flow measure captures the unconditional probability that an investor will encounter misconduct in their dealings with a financial adviser in a given year. Column (1) of Table 2 shows that the probability that an adviser engages in misconduct during a year is 0.60%. Approximately half of these misconduct-related disclosures arise from consumer disputes that were resolved in favor of the consumer. The third largest category, which captures approximately one in six disclosures, relates to actions taken by a regulator.

The second approach to measuring misconduct captures the prevalence of advisers in the population who have a record of past misconduct; i.e., it measures the stock of past misconduct at a given point of time. We measure the stock of misconduct as a binary variable that captures whether a financial adviser has a past record of misconduct. This measure broadly captures the unconditional probability that an investor will encounter an adviser with a past record of misconduct. Again, advisers with several records of misconduct in the past are recorded as having one instance of past misconduct. Column (2) of Table 2 indicates that 7.28% of financial advisers have at least one disclosure that is indicative of misconduct during their career. We calculate this stock measure of misconduct as the number of advisers with at least one misconduct disclosure during their career divided by the total number of advisers. Notably, because many financial advisers have multiple disclosures across multiple subcategories pertaining to misconduct, the subcategories of disclosure that we classify as misconduct in Table 2 add up to more than 7.28%.

One in thirteen advisers have a record of misconduct, suggesting that misconduct is relatively commonplace. To better understand the underlying reasons for customer and regulatory disputes, which represent the bulk of the disclosures, we analyze the text from descriptions of 116,826 disclosures from these categories across our sample period. Table 3a displays the eleven most common allegations cited. One in four disputes list “unsuitable” investments as an underlying cause of the dispute. This is not surprising. By law, brokers are required to only sell “suitable” investments to their clients. Misrepresentation or the omission of key facts together account for a third of disputes. Approximately 7% of allegations fall under the category of fraudulent behavior, which carries more severe penalties. The typical penalties associated with misconduct include fines, probation, and restitution. If convicted of criminal fraud, a financial adviser could face a prison sentence in addition to fines and probation. In Section 6 we revisit the classification of misconduct and analyze several different measures of misconduct. In particular, we construct an alternative measure of “severe” misconduct and find that our results are robust to this more restrictive classification as well.

We report the most common product categories involved in misconduct in Table 3b. The most popular investment products held by households - insurance, annuities, stocks, and mutual funds - are the products most commonly engaged in disputes (Campbell et al. 2010). Many of the misconduct disclosures pertain to variable rate annuities. Variable rate annuities have often been criticized in the public for having high fees and hidden charges (Kaplan 2010).

We examine the severity of misconduct by collecting the damages advisers pay to clients following misconduct. Figure 2 and Table 3c summarize the distribution of settlements. The median settlement for

misconduct is \$40,000, and the mean settlement is approximately \$550,000. Therefore, misconduct is costly for the advisory firm and suggests substantial damages to the household. To put these numbers in perspective, the median household net worth in the United States in 2011 was \$68,828. These figures suggest that the costs of adviser misconduct are substantial, with the median settlement equal to over half of the median household net worth. Overall, these facts suggest that the misconduct we measure is directly related to financial advisers' wrongdoing and fraud rather than simply clerical errors, mistakes, or ignorance on behalf of advisers.

Finally, we examine the amount of misconduct over time. Figure 3 shows that misconduct is not just a feature of the recent financial crisis. The incidence of misconduct is pervasive across the years in our sample. There is an increase in misconduct being disclosed in the aftermath of the recent financial crisis, but the incidence remains non-trivial across years.

### 3.2 Repeat Offenders

We start our analysis by exploring whether we can predict which advisers engage in misconduct. In particular, we are interested in repeat offenders, advisers who engage in misconduct more than once. Figure 4a displays the share of repeat offenders. Almost 8% of currently registered advisers engaged in misconduct at least once during their career. Of those, 27% are repeat offenders, having two or more disclosures of misconduct. This simple summary statistic strongly suggests that misconduct does not arise due to bad luck or random complaints by dissatisfied customers. If misconduct were random and/or the result of bad luck, the probability an average adviser would be a repeat offender is 2%, which is less than a tenth of the share in the data.<sup>11</sup>

At this stage, it is informative to contrast these statistics with those of physicians and public employees (Glaeser and Saks 2006). The annual incidence of misconduct among financial advisers is an order of magnitude larger than the incidence of corruption among public employees (less than 0.01%). The annual incidence of medical malpractice is similar to that of financial adviser misconduct, at roughly 1%. Medical malpractice, however, is substantially less concentrated among physicians, affecting more than half of physicians in the United States (Krupa 2010). This suggests that medical malpractice is quite random; sooner or later, most doctors are entangled one way or another. This is in contrast to financial advisers, in which misconduct is concentrated in around 8% of the active population.

The high incidence of repeat offenders suggests that past misconduct should predict future misconduct. Figure 4b investigates this claim by plotting the observed probability that an adviser is reprimanded for misconduct at time  $t$  conditional on whether he or she was reprimanded for misconduct at time 0. The figure illustrates that past offenders have an elevated probability of misconduct throughout their career.

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<sup>11</sup>Among those advisers who have a record of misconduct, we observe those advisers working for 3.60 additional years after their first misconduct disclosure in our data set. The baseline annual rate of misconduct in the data set is 0.60% (Table 2). If misconduct were completely random, we would expect the proportion of repeat offenders in the data set to be  $1 - (1 - 0.006)^{3.6} = 2.14\%$ .

Conditional on receiving a misconduct disclosure at time 0, the probability the adviser receives a misconduct disclosure in year one is 11%, roughly 4% in year five, and 1.50% in year nine. To put these numbers in perspective, the unconditional probability of receiving a misconduct disclosure in any one year is roughly 0.60%. Past misconduct not only predicts future misconduct in the short run but also the long run.

We now document which adviser characteristics, including past misconduct, predict new misconduct. Consider the probability that adviser  $i$ , at firm  $j$ , in county  $l$  is reprimanded for misconduct at time  $t$ . We estimate the following linear probability model:

$$Misconduct_{ijlt} = \beta_0 + \beta_1 PriorMisconduct_{ijlt} + \beta X_{ijlt} + \mu_{jlt} + \varepsilon_{ijlt} \quad (1)$$

The dependent variable  $Misconduct_{ijlt}$  measures the flow of new misconduct over a one year period and is a dummy variable indicating that the adviser received one or more misconduct disclosures at time  $t$ .  $PriorMisconduct_{ijlt}$  is the main independent variable of interest. It measures the stock of misconduct and is a dummy variable indicating if the adviser has a record of misconduct prior to time  $t$ .

To ensure that the correlation between past and future misconduct is robust, in some specifications we also control for firm- year-county fixed effects  $\mu_{jlt}$ .<sup>12</sup> In such a specification, we only exploit variation within the same firm, implying that we account for differences in firms' tolerance for misconduct as well as different business models firms may follow.<sup>13</sup> Moreover, since only within year variation is being exploited, any aggregate shocks to misconduct, such as the financial crisis, are also absorbed by this fixed effect. In addition, since we exploit variation within a location, these fixed effects also control for variation in regulatory conditions (subsuming any state- or county-level regulatory variation). Finally, these fixed effects also control for differences in demographics and labor market conditions in a given county at a point in time.

We also control for the adviser's characteristics in  $X_{ijlt}$ . Here we include several aspects of a financial adviser's registration: whether or not he or she has passed a qualifying exam to be registered as an investment adviser (Series 65 or 66) and the number of states he or she is registered in. We also control for other qualifications (Series 7, Series 63, etc.) and experience. Many of the requirements are at the state level and give financial advisers the flexibility to manage different types of accounts and assets. These proxy for the type of advising the adviser engages in.

Table 4 displays the estimates. The main coefficient of interest measures how likely an adviser with a record of past misconduct will engage in new misconduct relative to other advisers in his or her firm, in the same county, and at the same point in time. The coefficient of 2.40 percentage points suggests that the propensity for repeat misconduct is large. Given that the baseline rate of misconduct is 0.60%, the results suggest that financial advisers with prior misconduct are five times as likely to engage in new misconduct

<sup>12</sup>We define the firm fixed effect based on the underlying firm name and firm CRD# reported in BrokerCheck. If an adviser is registered with multiple firms in a year, we use the first firm listed at the start of the year. Roughly 1.5% of active advisers are registered with multiple firms. The county is determined based on the adviser's reported work address.

<sup>13</sup>For example, previous research by Qureshi and Sokobin (2015) finds that coworker misconduct is predictive of misconduct. The inclusion of firm by year by county fixed effects absorbs such firm level variation.

as the average financial adviser. We find that this relationship is very robust. In Section 6 we show this relationship holds under alternative definitions of misconduct, among investment advisers, and when we control for adviser productivity and quality.

One concern with our analysis above is that one offense, or a series of related events, could be recorded as multiple misconduct disclosures that span more than one calendar year. Consequently, the relationship between current and past misconduct we estimate in eq. (1) could be mechanical. Several observations suggest that this concern is not driving our estimate.<sup>14</sup> In particular, if the related misconduct disclosures are all reported within a year, then the issue does not arise. This is because we treat multiple instances as one event of misconduct. However, if reporting occurs across multiple years, then this could potentially impact our inferences. Figure 4b shows that past misconduct predicts future misconduct not only in the short run but also the long run, suggesting that this issue is not driving our estimate. More specifically, the figure suggests that an adviser who was reprimanded in the previous year is roughly 10pp more likely to engage in misconduct, but an adviser who was disciplined nine years earlier is also 1pp more likely to do so. It is possible that a series of related offenses that span more than one calendar year could potentially help drive the elevated probability of a repeat offense in years one and two observed in Figure 4b.<sup>15</sup> However, the longevity of the effect suggests that these are indeed separate offenses and not one isolated offense in an adviser’s career, which unfolds over the next few years. The coefficient on  $PriorMisconduct_{ijt}$  in Table 4 reflects a weighted average of the marginal effects reported in Figure 4b. The coefficient measures how likely an adviser with previous misconduct is to be reprimanded for misconduct in a given year relative to an adviser who has not been previously reprimanded, averaging across all prior misconduct. The overall incidence of repeated misconduct for an individual who has been previously reprimanded for misconduct is therefore greater than 2.40pp.

One interesting result in Table 4 is the relationship between the adviser qualifications and the probability of misconduct. Financial advisers who hold a Series 66 or 65 exam are more likely to be investment advisers. Relative to baseline rate of misconduct of 0.60%, the estimated coefficient of 0.31pp indicates that financial advisers that hold a Series 66 or 65 exam are 50% more likely to be reprimanded for misconduct relative to an average financial adviser. We also find a positive relationship between misconduct and adviser experience. However, the economic significance is small: a one year increase in experience is associated with a 0.0078pp increase in the probability of misconduct in a given year (Table 4 column 2).<sup>16</sup> We also find a

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<sup>14</sup>We find some evidence suggesting that the nature of the allegations are similar across repeat offenses. In untabulated results we find that among repeat offenders, advisers are 8-19pp more likely to engage in particular type of offense (in terms of the reported allegations) if they have previously done so.

<sup>15</sup>According to Qureshi and Sokobin (2015), “75% of the complaints that led to an award or settled above the CRD threshold reached a resolution within a year. Approximately 20% of the complaints resolved in the second year, whereas the resolution of the remaining 5% took more than 2 years.”

<sup>16</sup>One potential reason why we find a positive relationship between experience and misconduct may be that advisers with more experience have more opportunities to engage in misconduct, or that advisers early on in their careers are more risk averse. In untabulated results we investigated the role of experience further by including a dummy variable indicating whether an adviser has less than five years’ experience. When we include this dummy, we no longer find a statistically significant relationship between experience and misconduct; the estimated effect of experience is smaller at 0.0024pp. These results suggest advisers with little or no experience are driving the economically small but statistically significant positive relationship between experience and misconduct in the data.

negative relationship between the total number of other qualifications an adviser holds and the probability of misconduct. The estimated coefficient of  $-0.28pp$ , indicates that an adviser with one additional qualification is roughly 5% less likely to receive a misconduct disclosure in a given year. One potential explanation for this result is that those advisers with more qualifications may have more to lose if they are caught engaging in misconduct.

### 3.3 Misconduct Across Firms

Do firms differ in the amount of misconduct they generate? If firms are similar on the misconduct dimension, then an adviser fired by one firm for misconduct is unlikely a good match for other firms. If firms differ, however, then there is scope for reallocation of advisers. We first describe firms' adviser composition by measuring the percentage of employees who have a record of past misconduct. Figures 5a and 5b display the distribution of misconduct among firms with at least 100 and 1,000 advisers. In the average firm with at least 100 advisers, 8% of its financial advisers have records of past misconduct. The distribution is skewed strongly to the right. The median share of advisers disciplined for misconduct is 5%, and among firms in the top quartile, more than one in ten advisers have a record of past misconduct. This simple cut of the data shows that firms with clean records coexist with firms that engage in a substantial amount of misconduct.

Differences in the number of financial advisers with records of misconduct firms employ could arise because of differentiated business models. For example, some financial advisory firms could specialize in taking advantage of uninformed customers, while others use their clean image to attract more sophisticated customers. Another reason for heterogeneity could be differences in owners' risk tolerance of regulatory scrutiny.

Table 5 displays the twenty firms (80th percentile) with at least 1,000 advisers with the highest incidence of misconduct as of 2015. Misconduct is frequent at some of the largest financial firms in the United States. For instance, almost one in five financial advisers at Oppenheimer & Co. (CRD #249) have a record of past misconduct.<sup>17</sup> The misconduct rate is defined here simply as the percentage of advisers working for a firm that have been reprimanded for misconduct in the past. The misconduct rate reported in Table 5 may actually understate the true incidence of misconduct. When computing these numbers we include all financial advisers. However, not all financial advisers are in client-facing positions. A subset of the advisers in our data set may be in a non-client-facing position and would not be in a position to engage in misconduct. Thus, Table 5 reflects a lower bound on the probability a client would interact with an adviser with a past record of misconduct among one of these firms. We replicate Table 5 where we restrict our analysis to the set of client-facing financial advisers as discussed further in Section 6.5.1. The results suggest that the incidence of misconduct at firms such as Oppenheimer & Co could be closer to 25-28% rather than 19% reported here.

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<sup>17</sup>When asked about the results from this study, Oppenheimer & Co. had confirmed that they had "made significant investments to proactively tackle risk and compliance issues in our private client division. We've made changes in senior leadership, branch managers, and significant changes in our advisor ranks." (<http://www.bloomberg.com/news/articles/2016-03-01/it-just-got-even-harder-to-trust-financial-advisers>) [accessed on March 1, 2016]

We systematically explore whether observable firm characteristics are correlated with new misconduct using the following specification:

$$\begin{aligned}
 Firm\_Employee\_Misconduct_{jt} = & \beta_0 + \beta_1 Firm\_Employee\_Misconduct_{jt-1} \\
 & + \beta_2 Executive\_Misconduct_{jt-1} + \beta X_{jt} + \mu_t + \sum_{s=1}^{50} \mu_s State_{js} + \varepsilon_{jt}
 \end{aligned} \tag{2}$$

Observations are at the firm by year level over the period 2005-2015. Because we only observe registration details for active firms, we restrict our analysis to the set of firms still active as of 2015. The dependent variable  $Firm\_Employee\_Misconduct_{jt}$  measures the share of financial advisers working at firm  $j$  that were reprimanded for misconduct at time  $t$ . We include two variables that might shed light on the firm’s tolerance toward misconduct. First,  $Firm\_Employee\_Misconduct_{jt-1}$  measures the share of financial advisers that were working at firm  $j$  at  $t - 1$  that were reprimanded for misconduct in the previous year. Second,  $Executive\_Misconduct_{jt-1}$  is a dummy variable indicating that one or more of the firm’s owners or executives has a record of misconduct as of  $t - 1$ .<sup>18</sup> We lag the variable  $Executive\_Misconduct$  by one year to avoid any mechanical correlation between executive misconduct and  $Firm\_Employee\_Misconduct$ . We control for other dimensions of the firm such as its ownership structure, size, and quality. Our primary specification includes time fixed effects  $\mu_t$  to absorb aggregate variation in misconduct, and state fixed effects  $\mu_s$  for each state a firm operates in to control for differences in regulation and demographics.

The results reported in Table 6 show that observable firm characteristics predict firm-level misconduct. The estimates in column (4) indicate that misconduct is 40% more likely in firms in which an owner or executive has a record of misconduct.<sup>19</sup> We acquire data on the desirability of a firm using CVs in the database of a leading social networking website for professionals, assuming that firms with fewer followers are less desirable. More desirable or popular firms have lower incidence of misconduct on average. It is intuitive that more desirable, established firms that are run by executives with clean records are less likely to be associated with misconduct. It is important to keep in mind that in this section we use correlations to merely describe the data, and that the causality may be reversed. For example, we would expect that a firm that employs better financial advisers is more popular and long lived.

As with adviser-level misconduct, past firm misconduct predicts future misconduct. The coefficient of 0.33 suggests that a 1pp increase in the share of advisers who received misconduct disclosures in the previous year is correlated with a 0.33pp increase in new misconduct. Given that past offenses predict misconduct at the adviser level, it should not be surprising that they do so at the firm level as well. If advisers switch between firms rapidly, then misconduct may not be persistent at the firm level. Our results suggest that this

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<sup>18</sup>We observe the owners and executives for a firm as of 2015. Hence the variable  $Executive\_Misconduct_{jt-1}$  is a dummy variable indicating that one or more of the firm’s owners or executives as of 2015 had a prior record of misconduct as of time  $t - 1$ .

<sup>19</sup>We find that firms in which an owner/officer has been disciplined for misconduct have 0.22pp higher misconduct rates (column 4 of Table 6 ). On average, 0.60% of financial advisers receive misconduct disclosures in a given year. The rate of misconduct is  $0.22/0.6 = 37\%$  higher among those firms whose owner/executives have records of misconduct.

is not the case. Differences in misconduct across firms are predictable based on past misconduct and do not vanish in the span of a year.

## 4 Labor Market Consequences of Misconduct

In this section we examine the labor market consequences of misconduct for financial advisers. What punishment should we expect for misconduct? One benchmark is extreme punishment of misconduct where advisers who engage in misconduct are purged from the industry. Firms would fire advisers who engage in misconduct and would refuse to rehire advisers with a past record of misconduct. The alternative benchmark is extreme tolerance of misconduct. Of course, we expect reality to fall somewhere between these benchmarks. We now use the panel structure of our data to investigate how firms punish misconduct, and how advisers' misconduct records affect their employment dynamics.

### 4.1 Firm and Industry Discipline

The substantial presence of repeat offenders implies that the industry does not immediately purge advisers who have engaged in misconduct. Advisers may be forced out of the industry by firms or regulators. As a point of reference, FINRA either suspended or barred roughly 700 advisers in 2015 (“2015 Monthly and Quarterly Disciplinary Actions” 2015). We begin our analysis with a simple cut of the data. We examine average turnover rates among advisers with and without instances of misconduct in a given year in Table 7a. Misconduct is strongly correlated with job separation at the firm level. In the year following a misconduct disclosure, 48% of advisers leave their current jobs. This is substantially higher than the 19% rate for advisers with no instances of misconduct. Among advisers who leave their firm following misconduct, 44% are able to find employment within the same year.<sup>20</sup> Their reemployment prospects are only slightly worse than the 52% reemployment rate of advisers who left their firms with no instances of misconduct. These preliminary results are consistent with the notion that firms are relatively strict: roughly half of the advisers leave their firms in the year following misconduct. However, the industry undoes some of these effects. In particular, only about one-quarter of advisers leave the industry in the year following misconduct. The other three-quarters stay in the industry. Below, we examine these patterns in more detail and then document which firms hire advisers with misconduct records in Section 4.2.

#### 4.1.1 Firm Discipline

In this section we explore the relationship between job separation and misconduct at the firm-level in more detail. To evaluate firm level discipline, we would ideally compare employment outcomes of an adviser who engaged in misconduct to those of an otherwise identical adviser at the same firm at the same time. We

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<sup>20</sup>Most advisers who find new employment following misconduct are reemployed within the same year. Of those advisers who leave their firm following misconduct and find new employment within five years, 92% are reemployed within one year.

approximate this comparison as closely as possible by estimating the following linear probability model:

$$Separation_{ijlt+1} = \beta_0 + \beta_1 Misconduct_{ijlt} + \beta X_{it} + \mu_{jlt} + \varepsilon_{ijlt} \quad (3)$$

Observations are at the adviser by year level;  $i$  indexes an adviser who worked for firm  $j$  at time  $t$  in county  $l$ . The dependent variable  $Separation_{ijlt+1}$  is a dummy variable indicating that the adviser is *not* employed at firm  $j$  in year  $t+1$ . The independent variable of interest,  $Misconduct_{ijlt}$ , is a dummy variable indicating that adviser  $i$  received a misconduct disclosure in year  $t$ .

We control for adviser characteristics such as experience and qualifications in  $X_{it}$ . To control for differences in products or clients across firms, we include firm by year by county fixed effects  $\mu_{jlt}$ . For example, if employees of firms that are associated with more misconduct are more likely to switch jobs in a given year, then this correlation will be absorbed by the fixed effect. This fixed effect also absorbs any aggregate variation in the amount of misconduct and job separations. In addition, these fixed effects also capture any variation in regulatory conditions (subsuming any state-level regulatory variation), demographics, and local labor market conditions. In effect, we compare the outcomes of financial advisers who were employed at the same firm at the same time in the same county, but either did or did not engage in misconduct.

We present the estimates in columns (1)-(3) of Table 7b. In each specification we estimate a positive and statistically significant relationship between misconduct in year  $t$  and job separation in year  $t+1$ . The coefficient ranges from 24pp to 31pp across specifications with different controls and fixed effects. The coefficient of 31pp implies that, all else equal, misconduct is associated with a 31pp-higher chance of a job separation. These estimates are consistent with the simple summary statistics presented in Table 7a that suggested that advisers who are reprimanded for misconduct have a 29pp (48-19pp) higher probability of separation. To put these numbers in perspective, the baseline job separation rate in the population of advisers is 19%. This increase in job separation due to misconduct is two and a half times the mean separation rate in the data and is consistent with the idea that, on average, firms discipline misconduct quite heavily.

In Figure 2 we showed substantial differences in damages advisory firms pay as compensation for misconduct, ranging from tens to hundreds of thousands of dollars. One might expect more severe misconduct to be punished more severely. We restrict our attention to instances of misconduct for which we observe damages paid and estimate the following linear probability model:

$$Separation_{ijlt+1} = \beta_0 + \beta_1 \ln Damages_{ijlt} + \beta X_{it} + \mu_j + \mu_l + \mu_t + \varepsilon_{ijlt} \quad (4)$$

$Damages_{ijlt}$  measures the total sum paid out by adviser  $i$ 's firm  $j$  in year  $t$  and in county  $l$  to the client as the result of settlements and awards due to misconduct.

Columns (4)-(6) of Table 7b display the results. We find a positive relationship between damages and the probability of a job separation in each specification. A coefficient of 0.99 indicates that doubling of the awards paid to a client increases the probability that the adviser loses his or her job by approximately

1pp. Moving from the 25<sup>th</sup> to the 75<sup>th</sup> percentile of the distribution of settlements is associated with a 10pp-increase in job separations. This is a substantial increase relative to the unconditional mean separation rate of 19pp. These results are consistent with firms deliberately assessing the extent of misconduct before making a termination decision, rather than doing so randomly.

#### 4.1.2 Industry Discipline

Based on separation rates following misconduct, the average advisory firm seems to discipline employee misconduct quite severely. If individual firms are strict in disciplining bad employees, why are there so many repeat offenders in the population of financial advisers? To eliminate all repeat offenses, advisers would have to be fired following misconduct and not be reemployed in the industry. Instead, we find that 44% of advisers who lost their job after misconduct find employment in the industry within a year as shown in Table 7a. Following misconduct, 52% of advisers remain with their current firm, 21% ( $48\% \times 44\%$ ) join a new firm, and 27% leave the industry. Given that 9% ( $19\% \times 48\%$ ) of financial advisers leave the industry every year anyway, the disciplining mechanism at the industry level seems to be substantially less severe than suggested by the 48% separation rate at the firm level.

As the summary statistics suggest, using job separation alone to evaluate the success of “market discipline” is not sufficient, because a significant share of advisers who leave their firm upon misconduct find employment with a new firm. To understand the differences in reemployment prospects of advisers with misconduct, we estimate the following specification:

$$New\_Employment_{ij'lt+1} = \beta_0 + \beta_1 Misconduct_{ijlt} + \beta X_{it} + \mu_{jlt} + \varepsilon_{ijlt} \quad (5)$$

in which we restrict the sample to financial advisers who were separated from their firm in the previous year.  $New\_Employment_{ij'lt+1}$  is equal to one if adviser  $i$  in county  $l$  remains in the industry but has switched employers from  $j$  to  $j'$  between time  $t$  and  $t + 1$ . Columns (1)-(3) of Table 7c show a negative and significant relationship between misconduct and the probability an adviser finds new employment. Our results imply that, relative to other advisers looking for jobs, advisers who are reprimanded for misconduct at time  $t$  are 8 – 10pp less likely to find a new job in the next year. Given that the average probability an adviser will be reemployed is 52%, the results suggest that roughly 44% of advisers with recent misconduct are reemployed in the industry. Overall, financial advisers’ reemployment prospects are somewhat worse following misconduct, but the high reemployment rate allows approximately three-quarters of them to stay in the industry in the year following misconduct.<sup>21</sup>

As we show previously, advisers whose misconduct results in higher damages have an elevated probability

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<sup>21</sup>One potential concern is that some advisers may voluntarily leave the industry because of retirement. As a robustness check, we separately reexamine eq (5) where we restrict the data set to those advisers with less than 5, 10, 15, and 20 years of experience. In untabulated results we find that the effect of misconduct on new employment is the greatest for the least experienced advisers. These results suggest that more experienced financial advisers may be voluntarily retiring, but they are not the ones who drive the relationship between industry separation and misconduct in the data.

of losing their job. Does the labor market recognize the extent of cases of misconduct that lead to job separation? We examine whether larger damages lead to worse reemployment prospects of advisers. We estimate the following linear probability model:

$$New\_Employment_{ij't+1} = \beta_0 + \beta_1 \ln Damages_{ijlt} + \beta X_{it} + \mu_j + \mu_l + \mu_t + \varepsilon_{ijlt} \quad (6)$$

Columns (4)-(6) of Table 7c displays the results. The reemployment prospects of advisers whose misconduct resulted in larger damages are worse, even when comparing advisers who engaged in misconduct at the same firm, at the same time, in the same county, and with the same observable characteristics. They are more likely to exit the industry and less likely to find employment with another firm. These results suggest that the labor market for financial advisers is somewhat discerning when it comes to employing financial advisers with a history of misconduct; the labor market accounts for the severity of misconduct to some degree. Overall, the industry eliminates some advisers following misconduct, but is substantially less strict than firms individually. The reallocation of financial advisers to new firms partially blunts the firm-level response to misconduct. One puzzle that remains is why some firms are willing to hire advisers who were fired by other firms for misconduct. We examine this issue in Section 5.

## 4.2 New Employment

We document a relatively high rate of reemployment among advisers who lost their job following misconduct. One may argue that this evidence suggests that the cost of misconduct in the industry as a whole is low. On the other hand, just because an adviser is reemployed does not mean that misconduct is costless. Advisers lose income during temporary unemployment, and it may take effort to find jobs. Moreover, it is possible that when such advisers do find a job, the job is worse (i.e., at a less prestigious and/or worse-paying firm). Here we examine the duration an adviser is out of the industry following misconduct, as well as the characteristics of firms that hire advisers following misconduct. The reallocation of advisers across firms will help us better understand the costs of misconduct for financial advisers, as well as why some financial advisory firms are willing to hire advisers who were fired elsewhere for misconduct.

### 4.2.1 Duration Out of the Industry

We first examine the time it takes an adviser to find reemployment in the financial advisory industry by studying the 1,350,000 out of industry spells in our data set.<sup>22</sup> Figures 6a and 6b display the out of industry survival function for financial advisers who were and were not reprimanded for misconduct in the year preceding their out of the industry spell. Among those advisers who find new employment in the advisory industry, the vast majority find new employment within one year. Figure 6a indicates 47% of advisers

<sup>22</sup>We have 1.35mm separate observations where we observe a financial adviser leaving his/her firm over the period 2005-2015. Of those 1.35mm out of the industry spells, we observe 760k complete out of the industry spells where we observe a financial adviser leave his/her firm and find a position at a new financial advisory firm.

who were reprimanded for misconduct remain out of the industry after twenty-four months. In contrast, 45% of advisers who were not reprimanded remain out of the industry for the same duration. Overall, those advisers who were separated from their firms following misconduct remain out of the industry for longer periods relative to those advisers who were simply separated from their firms. A back-of-the-envelope calculation suggests that the costs amount to more than one month’s worth of wages.<sup>23</sup>

The simple non-parametric survival analysis in Figures 6a and 6b does not account for other differences among financial advisers, such as their experience or qualifications. We formally analyze the impact of misconduct on an adviser’s duration out of the industry by estimating the following Cox proportional hazards model:

$$\lambda_{it}(\tau) = \lambda_0(\tau) \exp(\gamma \text{Misconduct}_{it-1} + \beta X_{it} + \mu_t) \quad (7)$$

where  $\lambda_i(\tau)$  is the hazard rate of finding new employment in the industry for adviser  $i$  at time  $t$ , conditional on being out of the industry for  $\tau$  months. The hazard rate is a function of the baseline hazard  $\lambda_0(\tau)$  and changes proportionally depending on whether the financial adviser was reprimanded for misconduct in the year preceding the out of the industry spell,  $\text{Misconduct}_{it-1}$ , and the characteristics  $X_{it}$ . We also include time fixed effects  $\mu_t$  to account for aggregate fluctuations in the employment market.

The results presented in Table 8 confirm the raw data displayed in Figures 6a and 6b. The estimates in the table are reported in terms of hazard ratios. Any reported hazard ratio less than one suggests that the covariate is correlated with a longer duration out of the industry. The estimates in our main specifications (columns 1 and 2) suggest that an unemployed adviser who had engaged in misconduct in the year prior to the start of his or her out of the industry spell has a 17%-smaller chance of finding new employment in the industry at any given moment in time relative to an adviser without recent misconduct. In columns (3) and (4) we restrict our data to those spells of advisers who ultimately found a new job in the industry. Conditional on finding a job, advisers recently reprimanded for misconduct find these jobs at a marginally faster rate relative to those advisers without recent misconduct. Economically, the difference in hazards is relatively small: advisers who have recently been reprimanded for misconduct are 2.5% more likely to find a job in the industry at any given point in time relative to those who were not recently reprimanded for misconduct. There are several potential reasons for this result. For example, advisers who ultimately find reemployment following misconduct face scarcer employment opportunities in the industry, so they cannot afford to be as choosy. If they are offered a job, they are more likely to take it. Alternatively, conditional on finding the job, they have to be slightly better than candidates without misconduct to compensate for a worse disciplinary record. The results also suggest that the observed result that advisers with recent misconduct remain out of the industry for longer periods is driven by advisers who are not rehired in the industry after losing their previous employment. This finding is consistent with the simple summary statistics displayed in

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<sup>23</sup>We calculate the value of lost wages using the empirical survival functions that are reported in Figure 6a. The expected duration out of the industry is 29.21 months for those advisers without recent misconduct and is 30.23 for those adviser with recent misconduct. We calculate the expected duration out of the industry under the assumption that no adviser remains out of the industry after five years.

Figures 6a and 6b.

#### 4.2.2 Who Hires Offenders?

Approximately 44% of advisers who engage in misconduct and are separated from their jobs find new jobs as financial advisers within a year. We are broadly interested in two issues. First, we want to better understand the change in job quality that follows misconduct. If misconduct leads to a substantially worse job, then it is costlier than suggested by the reemployment statistics. Second, we are interested in why misconduct can persist in this market, and seeing who hires advisers with misconduct may offer a window into the mechanism at work.

We compare advisers who switched jobs following misconduct to other advisers who switched jobs from the same firm at the same time. Therefore, the advisers from the control group face the same labor market, are under the same regulatory rules, and are exposed to the same shocks as the adviser who engaged in misconduct. Further, because they were employed at the same firm, any firm-specific shocks or adviser characteristics which selected them into these firms are also accounted for. We estimate the following specification:

$$New\_Firm\_Characteristic_{ij't+1} = \beta_0 + \beta_1 Misconduct_{ijt} + \mu_{jt} + \varepsilon_{ij} \quad (8)$$

The dependent variable  $New\_Firm\_Characteristic_{ij't+1}$  measures the size, payout, firm desirability, revenue, and the amount of misconduct of the firm  $j'$  joined by adviser  $i$  who joined firm  $j'$  after leaving firm  $j$ .<sup>24</sup> The independent variable of interest is  $Misconduct_{ijt}$ , which is an indicator variable equal to one if the adviser was disciplined for misconduct in the year  $t$ , which is the year prior to leaving firm  $j$ . Here we include the previous firm by time fixed effects  $\mu_{jt}$  in our main specifications, and we find similar results when we include previous firm by time by county fixed effects as a robustness check. We also restrict the data set to only those initial firms  $j$  in which we observe both advisers with and without recent misconduct that switch firms.

Table 9 displays the results. Relative to other advisers who left the same firm at the same point in time, advisers with misconduct are hired in firms that pay almost \$15,000 less per year. We acquire data on the desirability of a firm using CVs in the database of a leading social networking website for professionals, assuming that firms with fewer followers/links are less desirable. Advisers move to substantially less popular firms following misconduct. Misconduct is costly even for advisers with new jobs, both in monetary terms as well as in compensating differentials.

These results also help us understand why firms employ advisers who were fired from other firms following misconduct. As we have shown, these firms differ from firms that would otherwise employ these advisers, in terms of compensation as well as prestige. Importantly, these firms are also more willing to employ advisers

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<sup>24</sup> Asset, revenue, and average payout/salary data comes from a private industry survey as of 2014. Data on social network followers/links comes from a leading social networking website for professionals and is as of 2015.

with misconduct records. We observe that, relative to other advisers who left the same firm at the same time, advisers who engaged in misconduct are hired by firms that employ a greater percentage of other advisers with past misconduct records (Table 9 column 3). In other words, after losing their jobs following misconduct, advisers are rematched with firms that are less concerned with misconduct. Notably, these firms are on average substantially smaller in dimensions of advisers, revenues, and assets under management (Table 9 columns 4-6). For example, advisers with recent misconduct move to firms that are 25% smaller in terms of the number of financial advisers the firm employs.<sup>25</sup> If firms were identical, some would not hire advisers who were fired from other firms following misconduct. Thus, “matching on misconduct” can rationalize why discipline is severe at the firm level, but substantially blunter at the industry level.

## 5 Why Is Misconduct Heterogeneous in Equilibrium?

The results in Section 3 indicate that firms and advisers with clean records coexist with firms and advisers who persistently engage in misconduct. Section 4 illustrates that engaging in misconduct is costly for advisers but not sufficiently for it to eliminate repeat offenders. Part of the reason is that advisers who lose their jobs following misconduct are reemployed by firms that “match” with these advisers and, in general, engage in more misconduct than an average firm. A natural question that arises is that given that the disciplinary record of every financial adviser in the United States is public record, why does reputation not drive out bad advisers or firms that employ them?

In this section we provide an interpretation for the descriptive statistics presented in Sections 3 and 4. We pursue two lines of inquiry. We first focus on differences in firms’ tolerance of misconduct. The previous section shows that advisers with misconduct sort to different firms than advisers without misconduct. We examine whether firms’ tolerance of misconduct differs when it comes to their hiring and firing decisions. Differences in hiring policies can help address *how* firms maintain different adviser pools over time. However, they do not explain why consumers keep coming back to firms with substantial misconduct. One potential reason why such firms can survive is if some customers are unsophisticated. Such customers do not know where to access financial adviser disclosures, how to interpret them, or that such disclosures even exist. It is well known that if there are differences in consumer sophistication, the market can be segmented. In such a scenario, some firms “specialize” in misconduct and attract unsophisticated customers, and others cater to more sophisticated customers and specialize in honesty, in the spirit of Stahl (1989) and Carlin (2009). The second part of our analysis examines this possibility by relating financial adviser misconduct to the sophistication of their potential customers.

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<sup>25</sup> Advisers with recent records of misconduct move to firms that have 1,898 fewer financial advisers (9 column 4). On average, advisers move to firms that employ 7,720 financial advisers.

## 5.1 Tolerance for Misconduct

### 5.1.1 Differences in Separation

The summary statistics presented in Section 3 suggest that some firms employ substantially more employees with past records of misconduct than other firms: the standard deviation of the firm share of employees with prior misconduct is 17pp (Table 1b). One possible reason is that some firms may be more tolerant of misconduct than others and are less likely to fire such employees. We investigate this hypothesis by exploring whether firms with a larger share of advisers with misconduct are more tolerant toward new misconduct using the following specification:

$$\begin{aligned} Separation_{ijlt+1} = & \beta_0 + \beta_1 Misconduct_{ijlt} + \beta_2 Firm\_Employee\_Misconduct_{jt} \times Misconduct_{ijlt} \quad (9) \\ & + \beta_3 X_{it} + \mu_{jlt} + \varepsilon_{ijlt} \end{aligned}$$

We build on the specification eq. (3) in Section 4.1.1. The variable of interest is  $Firm\_Employee\_Misconduct_{jt} \times Misconduct_{ijlt}$ . Recall that the variable  $Firm\_Employee\_Misconduct_{jt}$  measures the percentage of advisers employed by firm  $j$  that received misconduct disclosures at time  $t$ . The coefficient  $\beta_2$  measures how misconduct punishment at the firm level varies with the share of misconduct across firms. As in Section 4.1.1, we employ firm by year by county fixed effects, which absorb, among other confounds, the differences in firm level misconduct,  $Firm\_Employee\_Misconduct_{jt}$ .

We present the estimates corresponding to the above specification in column (1) of Table 10a. We estimate a negative and significant coefficient on the interaction term  $Firm\_Employee\_Misconduct_{jt} \times Misconduct_{ijlt}$ . The coefficient estimate of -3.10 suggests that firms that employ more employees with records of misconduct are also less likely to punish additional misconduct. Advisers who engage in misconduct at a firm, which is one standard deviation (3%3) above the mean in misconduct (0.5%), have only a 24pp higher probability of being separated from their jobs than advisers who did not engage in misconduct. This sensitivity is almost one-third (9pp) lower than that of an average firm. These results suggest that firms that employ advisers with prior offenses are also less likely to fire advisers for new offenses. A greater tolerance for misconduct should make these firms more attractive to advisers with a propensity to engage in misconduct, such as advisers with past misconduct records.

### 5.1.2 Differences in Hiring

We now explore if firms also differ in their tolerance for misconduct in hiring decisions. In particular, we ask if some firms are more likely to hire advisers that have been previously disciplined for misconduct. We do so by investigating the composition of newly hired advisers using the following specification:

$$Share\_of\_New\_Hires\_Disciplined_{jt+1} = \beta_0 + \beta_1 Firm\_Employee\_Misconduct_{jt} + \mu_s + \mu_t + \varepsilon_{jt} \quad (10)$$

The dependent variable reflects the share of new employees that were hired by firm  $j$  at time  $t+1$  that were disciplined at time  $t$ . The corresponding estimates are reported in Table 10b. Firms with a higher proportion of advisers with incidences of misconduct at time  $t$  hire a larger share of advisers at time  $t+1$  who were disciplined for misconduct at time  $t$ . The coefficient estimate in column (1) indicates that a one-percentage-point increase in a firm’s share of advisers with misconduct at time  $t$  is associated with a 0.72pp higher incidence of hiring advisers with misconduct. Overall, the results presented in Tables 10a and 10b suggest that firms with a higher proportion of advisers with misconduct are more tolerant of misconduct in their hiring and firing decisions.<sup>26</sup>

## 5.2 Customer Base and Incentives

In this section we explore whether firms that specialize in market segments with less sophisticated investors also engage in more misconduct. As mentioned earlier, such segmentation would provide one possible reason why firms that persistently engage in misconduct can survive in the market next to firms that have relatively clean records.

### 5.2.1 Retail Clients, Fee Structure, and Misconduct

The Investment Company Act of 1940 considers high net worth individual or “qualified purchasers,” to be more sophisticated than smaller retail investors, allowing them substantially more latitude in their investments.<sup>27</sup> One might expect misconduct to be directed at less sophisticated investors, who are easier to ensnare. Alternatively, defrauding large investors may be more profitable, since they have more wealth. In this section we use additional information on the client base as well as fee structures across investment advisory firms and relate them to misconduct across firms. To do this analysis, we gather data from the SEC’s Form ADV filings. In these filings, investment advisory firms disclose information on their clientele and business practices. As discussed in detail when presenting our data in Section 2, investment advisers are registered with the SEC and face different regulatory requirements than brokers. Since not all financial advisory/brokerage firms are registered as investment advisory firms, we only observe the Form ADV filings for 441 unique firms in our data set over the period 2011-2014.

We formally examine how the client base and fee structure of financial advisory firms correlate with misconduct. We estimate the following specification:

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<sup>26</sup>As an extension, in the Online Appendix we also find that firms that punish misconduct more severely are also less likely to hire advisers with past misconduct records. We construct a new variable  $Firm\_Discipline_{jt}$ , which measures the percentage of financial advisers working for firm  $j$  who experienced job separations at time  $t+1$  among those advisers working for firm  $j$  who engaged in misconduct at time  $t$ . We interpret that firms with higher measures of  $Firm\_Discipline_{jt}$  discipline misconduct more severely. Moving from the 25th to the 75th percentile of the distribution of  $Firm\_Discipline_{jt}$  is associated with a 58bp lower incidence of misconduct among new hires.

<sup>27</sup>Section 2(a)(51)(A) of the Investment Company Act of 1940.

$$Firm\_Employee\_Misconduct_{jt} = \beta_0 + \beta_1 Retail\_Firm_{jt} + \sum_{k=1}^K \beta_k Compensation\_Structure_{kjt} + \varepsilon_{jt} \quad (11)$$

The key independent variable of interest is a dummy variable,  $Retail\_Firm_{jt}$ , that indicates whether or not firm  $j$  serviced retail clients (non-high net worth individuals, families, and households) in year  $t$ . We also control for a set of dummy variables,  $Compensation\_Structure_{kjt}$ , that measure how the advisory firm charges for its different services in a given year  $t$ . The various compensation structures  $k$  include hourly fees, fixed fees, fees based on assets under management, commissions, and performance. The compensation structures are not mutually exclusive, and many firms use a variety of methods to charge for services.

We present two different measures of  $Firm\_Employee\_Misconduct_{jt}$ . First, we measure it as the flow of new misconduct: the share of advisers working for firm  $j$  that received misconduct disclosures in year  $t$ . The second measure is the stock of misconduct: the share of advisers working for firm  $j$  that have been ever been disciplined at or prior to time  $t$ . Table 11 column (4) shows that firms that advise retail clients are 0.2pp more likely to engage in new misconduct. Relative to the mean rate of new misconduct of 0.6pp, this is a substantial increase. Similarly, column (1) of Table 11 indicates that firms that advise retail clients are 3.4pp more likely to employ an adviser who has a record of misconduct. We also find evidence that firms that charge hourly are more likely to engage in new misconduct, and have a higher stock of advisers who have engaged in misconduct in the past. Similarly, firms that charge a commission have a higher stock of advisers who have engaged in misconduct in the past. These results suggest that there is some market segmentation on misconduct, which is more likely targeted at unsophisticated retail investors.

### 5.2.2 Firm Location and Customer Base

An alternative way to measure the sophistication of firms' customer base is to study the population characteristics of markets in which the firm is located. Tables 12a and 12b report the counties with the highest and lowest rates of misconduct among those counties with at least one hundred registered advisers. Almost one in three advisers in Madison County, New York, have a record of past misconduct, relative to only one in thirty-eight advisers in Franklin County, Pennsylvania.<sup>28</sup> Figure 7 supports the idea of substantial geographic differences in misconduct: Florida, Arizona, and California have some of the highest rates of financial misconduct, while the rates are lowest in the Midwest. We next examine whether misconduct is more prevalent in markets with a larger share of individuals who are often deemed less financially sophisticated, such as older, less educated individuals (see Hall and Woodward 2012; Gurun et al. 2015). To do so, we investigate whether the variation in misconduct rate in a region is explained by observable county

<sup>28</sup>Following the release of the working paper, New York Times journalist Ron Lieber examined advisers in Madison County, New York, and found evidence consistent with our facts.

Lieber, Ron. 2016. "Should Trump Undo Investor Protections? Meet the Brokers of Madison County." New York Times. [https://www.nytimes.com/2016/11/19/your-money/brokerage-and-bank-accounts/trump-repeal-retirement-rules-brokers-madison-county.html?smid=tw-share&\\_r=0](https://www.nytimes.com/2016/11/19/your-money/brokerage-and-bank-accounts/trump-repeal-retirement-rules-brokers-madison-county.html?smid=tw-share&_r=0) [Accessed on 1/11/2017]

characteristics using the following specification:

$$County\_Misconduct_{lst} = \beta X_{lst} + \mu_t + \mu_s + \varepsilon_{lst} \quad (12)$$

The unit of observation is at the county by year level over the period 2010-2013.<sup>29</sup> We use two definitions of the dependent variable  $County\_Misconduct_{lst}$ . The first is defined as the flow of new misconduct, measured as the percentage of advisers living in county  $l$  and state  $s$  that received misconduct disclosures at time  $t$ . The second measures the stock of misconduct, defined as the percentage of advisers living in county  $l$  and state  $s$  who ever received one or misconduct disclosures at or prior to time  $t$ . The independent variables of interest are measures of financial sophistication, such as education and the share of retirees in the population. We also control for other county demographic characteristics that may be correlated with demand for financial advice, such as income (log median household income) and population size. We control for time fixed effects  $\mu_t$  to absorb aggregate variation in misconduct, and include state fixed effects  $\mu_s$  to account for regulatory differences across states, which may lead to different amounts of misconduct.

The results are reported in Table 12c. We find that counties with a smaller share of college graduates and a larger share of retirees experience more misconduct and employ more advisers with past misconduct records. The estimates in column (3) indicate that a 10pp increase in the number of individuals older than 65 is correlated with an approximately 0.34pp increase in the percentage of advisers who are reprimanded for misconduct in a given year. Similarly, a 10pp increase in the share of college-educated individuals decreases the percentage of advisers who are reprimanded for misconduct in a given year by 0.19pp. These estimates are substantial relative to the mean misconduct rate of 0.6pp. These results suggest that financial misconduct is more prevalent in areas with less financially sophisticated, older populations and less educated individuals. We also find a correlation between other demographics, which would proxy for demand for financial advice, and misconduct. Higher-income counties, for example, experience more misconduct. The estimates in column (3) suggest that a 10% increase in income is associated with a 0.06pp increase in the percentage of advisers who are reprimanded for misconduct in a given year. Misconduct may be more profitable in high-income counties. Our analysis thus focuses on reported/detected misconduct which is a function of both the incidence of misconduct and the detection technology. It's possible that misconduct is higher in areas with more elderly, less educated, and wealthier populations because these populations are better at detecting misconduct. We examine the role of misconduct detection in Section 6.2 and show that these findings are not driven by differences in misconduct detection. Overall, our results support the notion that the presence of financially unsophisticated investors allows misconduct to persist in the market for financial advice.

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<sup>29</sup>To help rule out potential outliers, we restrict the data set to counties with at least 50 advisers. The results presented in the table are not sensitive to this criterion. Due to the availability of data, we estimate our specification at the county by year level using an unbalanced panel of 667 counties over the period 2010-2013.

## 6 Robustness and Extensions

We now discuss the robustness and several extensions of our findings. For brevity, we relegate some additional robustness checks to the Online Appendix.

### 6.1 Measurement Error in Measuring Misconduct

We define our measure of misconduct based on the twenty-three disclosures categories reported by FINRA. Here we examine the robustness of our findings to alternative definitions of misconduct and address potential measurement error issues. In this section we construct several alternative “severe” measures of misconduct that are more definitive cases of adviser dishonesty. We also separately analyze each of the 23 disclosure categories reported by FINRA. Our main findings are robust to these alternative definitions of misconduct.

#### 6.1.1 Alternative Misconduct Definition - Restricting our Analysis to “Severe Misconduct”

We construct two additional measures of misconduct that are more definitive cases of adviser dishonesty. Specifically, we analyze the reported client allegations pertaining to misconduct related disclosures to construct two alternative measures of misconduct, “*Severe Misconduct-1*” and “*Severe Misconduct-2*”. We define the new category “*Severe Misconduct-1*” as any settled regulatory, civil, or customer dispute involving: unauthorized activity, fraud and forgery, churning, selling unregistered securities, misrepresentation, and/or omission of material/key facts. In our “*Severe Misconduct-1*” category we also include finalized criminal cases involving: investment (including checking account) related activities and fraud and forgery. We define a new more restrictive category “*Severe Misconduct-2*” using the same definition as “*Severe Misconduct-1*,” except we exclude settled regulatory, civil, or customer disputes involving misrepresentation and/or omission of material/key facts. As before, we are conservative in how we define “*Severe Misconduct-1*” and “*Severe Misconduct-2*.” Just because a misconduct related disclosure (under our baseline definition) is not classified as either “*Severe Misconduct-1*” and/or “*Severe Misconduct-2*” does not necessarily mean the misconduct event was less severe. Rather, it potentially means that the reported allegations were too vague to definitively classify the disclosure event as being severe and/or dishonest misconduct. As a point of reference, the median settlement amount is \$40,000 for our baseline definition of misconduct, \$47,036 for “*Severe Misconduct-1*,” and \$50,000 for “*Severe Misconduct-2*.”

We examine our baseline analysis, the probability of recidivism, job separation, and industry separation using our two alternative definitions of misconduct. Regardless of how we define misconduct, we find that past misconduct is highly predictive of future misconduct. The labor market consequences of our measures of severe misconduct are also comparable to our baseline definition of misconduct. Firms appear to discipline severe misconduct relatively harshly; 44-50%, of advisers experience job separations after being reprimanded for misconduct. However, the industry undoes some of the firm discipline. Of those advisers who experience a job separation following severe misconduct, 41-45% are able to find new employment in the financial advisory

industry within a year.

### 6.1.2 Other Types of Disclosures Besides Misconduct

As noted earlier in Section 3, our classification scheme is conservative since we categorize only six of twenty-three categories of disclosure as misconduct, focusing on categories for which misconduct is clear. However, statistically one would expect other disclosures to also be somewhat indicative of misconduct. For example, an adviser engaged in a pending consumer dispute is more likely to have engaged in misconduct than an adviser who was not involved in a dispute in the first place.

We separately examine each disclosure category and whether or not it predicts future misconduct and the associated labor market consequences. We find that each one of the six misconduct disclosure categories is correlated with a higher incidence of misconduct in the future. Interestingly, several “Other Disclosures” categories also predict future misconduct to some extent, such as customer disputes that were withdrawn or denied, suggesting that disclosing these categories may be valuable to potential consumers trying to avoid advisers who are more likely to engage in misconduct in the future.

We also explore whether advisers experience employment separations following different types of disclosure. We find that five of the six disclosure categories that we classify as misconduct are associated with higher rates of job separation and the relationships are statistically significant at the 1% level. The one exception is misconduct disclosures classified as “Customer Dispute - Award/Judgment.” On the other hand, the other disclosures that we do not classify as misconduct are in general not associated with higher job separation rates. We do find that disclosures in which a customer dispute was denied or closed do lead to increased job separation rates. These results suggest that perhaps our categorization of misconduct is conservative. Overall, some of the non-misconduct/other disclosures also predict future misconduct, and advisory firms seem to partially account for that in their employment decisions.

Lastly, we reestimate the Cox proportional hazard model to assess the length of time it takes for advisers to find new employment in the industry for those advisers who lost their jobs following a disclosure (eq. 7). For each category of disclosure we categorize as misconduct, the coefficient is statistically different from 1. Interestingly, while most of these categories imply longer out of the industry spells, some categories – in particular, criminal case and customer dispute settlement – do see faster employment outcomes. This might be the case since in situations like these, the adviser might have started looking for a job well in advance, once it was clear that he or she might have to leave his or her existing firm consequent to the discovery of the misconduct. Also the differences in spell lengths across categories could reflect differences in resolution times. An adviser’s current employer and potential new employers may wait for certain disclosures to be resolved before making hiring and firing decisions.

## 6.2 Differences in Detection

What we observe in the data is misconduct that was reprimanded. In other words, we only observe misconduct that was both detected and resulted in a settlement/judgment against the financial adviser. Thus, our measure of misconduct does not capture all misconduct occurring in the financial advisory industry but only the misconduct that was detected. To the extent that misconduct goes undetected, we likely underestimate the total amount misconduct in the financial advisory industry. The variation in detected misconduct is a function of both the total level of misconduct and detection intensity. For the purposes of our data descriptive analysis presented in Sections 3 and 4, the measure of interest is detected misconduct rather than total misconduct. Distinguishing between detected and total misconduct becomes relevant when discussing the results reported in Section 5, where we develop a framework for understanding and interpreting why misconduct varies across advisers and firms.

In particular, some of the observed heterogeneity in our measure of firm employee misconduct may not only be driven by a firm's tolerance towards misconduct but also variation in misconduct detection. For instance, our finding that firms that service retail clients have higher rates of misconduct could be driven by retail consumers simply being better at detecting misconduct. To explore this alternative explanation, we separately examine misconduct based on who detected the misconduct. In the data we observe whether or not the misconduct disclosure was initiated by a customer, firm, or regulator. In particular, we estimate eq. (11) where we separately calculate the firm misconduct rate based on whether the misconduct proceedings were initiated by a customer or a non-customer (i.e., firm or a regulator).

We find that firms that target retail clients are more likely to employ an adviser with a record of misconduct, regardless of whether the claims faced by advisers of the firm were initiated by a customer or non-customer. This analysis suggest that our previous result that misconduct is higher among firms that service retail clients is not purely driven by customers' differences in misconduct detection; rather, it is driven by certain firms engaging in misconduct and targeting retail investors. Similarly, the issue of total versus detected misconduct could also drive some of our previous findings in which we explored what regional characteristics were related to misconduct by firms operating in these regions. For instance, our finding that misconduct is higher in areas with less educated and more elderly populations could be driven by less educated and elderly individuals being better at detecting misconduct. As a robustness check, we reestimate eq. (12) where we again separately examine those misconduct disclosures that were initiated by customers and non-customers. We find that the level of misconduct, regardless of whether a customer or non-customer initiated the claim, is higher in areas with less educated and more elderly individuals. These results provide further evidence suggesting that our findings are more consistent with firms targeting less educated and elderly individuals.

### 6.3 Accounting for Endogenous Separation

In Section 4.2 we compare the new employment outcomes of those advisers who were and were not recently reprimanded for misconduct. In particular, we compare the employment outcomes of advisers who were reprimanded for misconduct and switched jobs with a “control group.” The control group consists of advisers who were employed at the same firm at the same time who also switched jobs. One might be concerned that the control group does not accurately represent the average adviser at the firm. Advisers who switch jobs with clean misconduct records could do so because better employment opportunities came along. Then they would be better than the average employee at the firm. Alternatively, it may be that, on average, worse advisers leave the firm.

In order to address this concern, we focus on firms in which all advisers were forced to look for new employment because the firm was dissolved - for example, because it was going out of business. We compare employment outcomes of advisers from the same firm with and without misconduct after the firm dissolves. The difference from our previous test is that *all advisers in this sample have to find new jobs*, regardless of their past misconduct or quality. Therefore, we are comparing the employment outcomes of the average employee with misconduct to the average employee without misconduct. We have 124,696 adviser by year observations that were preceded by a firm dissolution. Roughly 75% of the observations are triggered by the dissolution of firms with at least 100 employees. Firm dissolutions are the result of firms going out of business, being shut down by regulators, mergers, acquisitions, reorganizations, etc.

We first examine the probability that advisers find new jobs in the industry after their firms dissolve, following our previous specification (eq. 5). We find that advisers with recent misconduct are 16-23pp less likely to find new employment within the industry. We also examine the differences in jobs that advisers with and without misconduct obtain following firm dissolution (eq. 8). We again find that advisers with recent misconduct tend to move to firms with higher rates of misconduct (0.34pp higher) and move to smaller firms (830 fewer advisers). Overall, these results confirm that the choice of control group does not seem to be driving our results that advisers with recent misconduct face longer spells out of the industry and tend to sort to smaller firms with higher rates of misconduct.

### 6.4 Investment Advisers versus Non-Investment Advisers (Brokers)

We examine how our main results regarding the incidence and consequences of misconduct may vary across investment advisers and non-investment advisers. We find that, in general, similar patterns emerge across the groups but to differing degrees. As we discuss in Section 2, the differences between the two groups are important and could arise for several reasons since investment advisers face different legal and regulatory requirements from non-investment advisers, such as brokers, and provide different services to potentially different clientele. A key difference between the two groups is that investment advisers are held to a fiduciary standard while brokers are held to a lower suitability standard.

A financial adviser can be solely registered as a broker with FINRA, solely registered as an investment adviser with the SEC, or dually registered as a broker with FINRA and as an investment adviser with the SEC. Recall that the BrokerCheck data set only includes those financial advisers who are registered with FINRA. As of 2015, there are 644k financial advisers registered with FINRA, and 271k of those advisers are also registered as investment advisers with the SEC. There are an additional 51k investment advisers that are solely registered with the SEC. These solely registered investment advisers are not part of our original data set. To examine these additional investment advisers, we supplement our BrokerCheck data set with additional data from the SEC’s Investment Adviser Public Disclosures (IAPD) database. The SEC IAPD classifies disclosures into nine categories: customer disputes, bankruptcy, criminal, regulatory, termination, judgment, civil, bond, and investigation. We construct the corresponding categories from the 23 disclosure categories specified in FINRA’s BrokerCheck database. We separately examine the disclosure patterns for those advisers that are solely registered with the FINRA, solely registered with the SEC, and those dually registered. In general, dually registered financial advisers are more likely to have disclosures on their records than those advisers who are solely registered with either FINRA or the SEC. Roughly 22% of dual registered advisers have disclosures on their records, while 11% of advisers solely registered with FINRA and 12% of advisers solely registered with the SEC have disclosures on their records.

We also reestimate our main specifications separately for those FINRA registered representatives that are and are not also registered as investment advisers.<sup>30</sup> The main results hold for both populations, but to differing degrees. We find that FINRA registered investment advisers are more likely to be reprimanded for misconduct than non investment advisers, but face less punishment at both the industry and firm levels. These differences could potentially be driven by differences in clientele or regulatory requirements/supervision.

## 6.5 Additional Adviser Controls

Throughout our analysis we control for an adviser’s qualifications and experience. We also include firm by year by county fixed effects such that we are exploiting variation within the same firm, in a given location, and in a given year. Although our set of controls should largely capture differences across firms and adviser job functions, we run several robustness checks where we restrict our data set to those advisers that are in client-facing positions and control for other measures of adviser quality and productivity. To measure adviser quality and control for other job characteristics, we supplement our financial adviser data set with additional data from Meridian IQ. The Meridian IQ data set contains additional adviser level data on the productivity and job position of currently active financial advisers. We are able to match 85% of the currently active financial advisers in our FINRA data set to the Meridian IQ data.

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<sup>30</sup>We only observe whether a financial adviser is registered as an investment adviser if the financial adviser is currently active in the industry. Hence, we treat all advisers who have completed an investment adviser examination (Series 65 or 66 exam) as investment advisers.

### 6.5.1 Client-Facing Advisers

We do not directly observe whether or not a financial adviser is in a client-facing position in our baseline data set. We determine whether or not an adviser is in a client-facing position using two separate methods. First, we supplement our financial adviser data set with data from Meridian IQ which includes information about which advisers are client-facing. Second, we define client-facing advisers as those currently active advisers registered in more than three states. As discussed in Qureshi and Sokobin (2015), they report that "Based on its experience, FINRA staff believes that brokers with more than three state registrations generally deal with public investors."

We reestimate our baseline results where we restrict our data set to the set of currently active financial advisers that are in client-facing roles.<sup>31</sup> We find that those advisers with past records of misconduct are more likely to engage in future misconduct, regardless of how we define "client-facing." Similarly, we find that those advisers with recent misconduct disclosures are 17pp more likely to experience job separations. The estimates are qualitatively and quantitatively similar to our baseline set of results.

### 6.5.2 Controlling for Adviser Quality and Productivity

The Meridian IQ data set includes additional information on the quality and productivity of a financial adviser for a large subset of the active financial advisers in the data set. We replicate our baseline set of results where we control for the adviser's current quality rating, assets under management (AUM), and productivity/revenue as of 2016.<sup>32</sup> Our main results are robust to the inclusion of additional controls. We find that those advisers with a past record of misconduct are 1.4pp more likely to receive a misconduct disclosure in a given year. The results also indicate that more productive advisers are also more likely to have misconduct disclosures, though the effects are economically small. For example, we estimate that a 10% increase in AUM is associated with a 0.005pp increase in the probability of receiving misconduct disclosure in a given year. After controlling for productivity and quality differences, we again find that those advisers with recent misconduct disclosures are 9-15pp more likely to experience employment separations in the proceeding year. We also find that advisers that are more productive (in terms of AUM and revenue) and that are higher quality are less likely to experience job separations. For example, advisers with a high quality rating are 4% less likely to experience job separations. Overall, our main results regarding the high rates of recidivism and career punishments do not appear to be driven by productivity and adviser quality differences.

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<sup>31</sup>We only observe Meridian IQ data for currently active financial advisers in our data set. Similarly, we only observe the number of state registrations for the current set of active financial advisers. Hence, our analysis regarding client-facing advisers is restricted to the set of financial advisers that are currently active.

<sup>32</sup>Meridian IQ also generates a proprietary measure of adviser quality. The control variable High Quality Rating indicates a high rating as of July 2016.

## 7 Conclusion

We document substantial misconduct among financial advisers in the United States. More than 7% of financial advisers have been reprimanded for misconduct. The costs of misconduct are not small: the mean settlement amount is \$550,000. Misconduct varies dramatically across advisers and firms, and repeat offenders are common. Although advisers face consequences for misconduct, the majority of advisers remain in the industry following misconduct. More than 50% remain with the same firm after a year, and 20% switch to a different firm in the industry. The firms that hire advisers after misconduct-driven separation have advisers with higher rates of prior misconduct. This evidence suggests that some firms “specialize” in misconduct. This “match on misconduct” reemployment potentially undermines the disciplining mechanism in the industry, lessening the punishment for misconduct. We argue that heterogeneity in consumer sophistication could explain the prevalence and persistence of misconduct at such firms. Our results suggest that misconduct is widespread in regions with relatively high incomes, low education, and elderly populations. These results suggest that firms that consistently engage in misconduct are likely targeting vulnerable consumers, while other “clean” firms use their reputation to attract sophisticated consumers.

Our estimates likely understate the true extent of misconduct in the industry for several reasons. First, it is likely that not all misconduct is detected/reported. Second, we do not classify pending consumer complaints and several other disclosure categories, some of which are acts of misconduct, as misconduct. Third, while we show that the average penalty for cases in the data is large, the penalties themselves are decided by arbitration committees, which have been accused of being favorable to the industry (Bernard 2014). Fourth, if some advisers do not have an opportunity to engage in misconduct, because of their job assignment (e.g. a non-client-facing position), then our estimates will be a lower bound for misconduct among those advisers that have the opportunity to do so. Finally, our numbers would also be a lower bound if adviser disclosures or other adverse information about advisers were expunged (Antilla 2014).

More broadly, studying financial advisers provides a lens into markets in which sellers are experts relative to their customers. For example, it is difficult for consumers to ascertain the value of services provided by such professionals as doctors, attorneys, accountants, car mechanics, and plumbers. In these markets, trust and reputation are supposed to prevent the supply of poor services. Disclosure of financial advisers’ misconduct is public, providing a “market mechanism” that should prevent and punish misconduct. Given our findings, in markets with less disclosure, misconduct may be even more difficult to eradicate through competition alone.

Two related questions naturally arise. First, is the extent of misconduct punishment optimal from the perspective of individual firms? Second, is the extent of misconduct punishment in the market socially optimal? We can use the estimates from Section 3 to provide a back-of-the-envelope estimate of the firm’s costs and benefits of firing an employee with a recent misconduct record. The benefit of firing an employee following misconduct arises from preventing future misconduct related costs. Advisers who engaged in misconduct in the previous year are 10pp more likely to engage in misconduct the following year (Figure

4b). Given that the average settlement cost is \$550,000, these simple summary statistics suggest that firing an adviser prevents expected misconduct costs of \$55,000 in the first year following misconduct. The cost of firing an adviser reflects the opportunity costs of losing the adviser and her clients. In Section 6 we find that more productive advisers are less likely to be fired following misconduct. Advisers who kept their job following misconduct generate an additional \$52,000 in annual revenue relative to those who were fired.<sup>33</sup> These back-of-the-envelope calculations are extremely simple and rely on average, rather than marginal, costs and benefits. Nevertheless, the estimates of expected costs and benefits of firing advisers following misconduct are quantitatively close, suggesting that the average financial advisory firm is somewhat profit maximizing when considering how it punishes misconduct.

Evaluating whether the market punishment of misconduct is too lenient or too harsh from the perspective of society is substantially more difficult. Punishing misconduct is subject to Type I and Type II errors. To compute the optimal punishment, we would need estimates of the social costs for each of these errors, as well as the extent of these errors. One way to illustrate why inferences about the optimal level of punishment are difficult is to compare the misconduct rate of financial advisers to that of medical malpractice. As discussed in Section 3.2, the baseline rate of financial misconduct is similar to the rate of medical malpractice. Surely, one would be hard pressed to argue that the social costs of Type I and Type II errors for financial adviser misconduct are similar to the costs of medical malpractice. Therefore, it is difficult to conclude that there is too much (or too little) misconduct in the financial advisory sector. What is clear is that the labor market punishes misconduct to some extent, rejecting both the benchmark of no punishment as well as the benchmark of extreme punishment we discussed in the introduction.

Our findings also suggest that the current structure of penalties or reputation concerns may not have been 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. Several recent efforts by regulators, such as the establishment and promotion of FINRA's BrokerCheck website, have been along these lines. Proposals to increase penalties for misconduct could also potentially decrease financial misconduct. Another policy proposal in this area is the Department of Labor's initiative to mandate a fiduciary standard for all financial advisers. Interestingly, we also find similar patterns of misconduct among investment advisers who are already subject to fiduciary standards. This result suggests that fiduciary standards may not be a simple solution to decreasing misconduct.

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<sup>33</sup>Using Meridian IQ data, we compare the average productivity of advisers who kept their jobs following misconduct (\$659k) with those who experienced employment separations following misconduct (\$607k).

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Table 1: Adviser and Firm Summary Statistics

| (a) Adviser Summary Statistics     |           |       |           |        |  |
|------------------------------------|-----------|-------|-----------|--------|--|
| Variable                           | Obs       | Mean  | Std. Dev. | Median |  |
| Experience (years)                 | 7,946,680 | 11.25 | 9.60      | 9.00   |  |
| Registration:                      |           |       |           |        |  |
| Currently Registered               | 7,946,680 | 69.8% |           |        |  |
| Registered as IA                   | 5,544,727 | 51.4% |           |        |  |
| Disclosures:                       |           |       |           |        |  |
| Disclosure (flow in one year)      | 7,946,680 | 1.62% |           |        |  |
| Misconduct (flow in one year)      | 7,946,680 | 0.60% |           |        |  |
| Disclosure (stock)                 | 7,946,680 | 12.7% |           |        |  |
| Misconduct (stock)                 | 7,946,680 | 7.28% |           |        |  |
| Exams and Qualifications (Series): |           |       |           |        |  |
| No. Qualifications                 | 7,946,680 | 2.92  | 1.37      | 3.00   |  |
| Uniform Sec. Agent St. Law (63)    | 7,946,680 | 77.1% |           |        |  |
| General Sec. Rep. (7)              | 7,946,680 | 68.0% |           |        |  |
| Inv. Co. Products Rep. (6)         | 7,946,680 | 39.9% |           |        |  |
| Uniform Combined St. Law (66)      | 7,946,680 | 21.3% |           |        |  |
| Uniform Inv. Adviser Law (65)      | 7,946,680 | 20.5% |           |        |  |
| General Sec. Principal (24)        | 7,946,680 | 15.8% |           |        |  |

| (b) Firm Summary Statistics                 |           |        |         |           |         |
|---|-----------|--------|---------|-----------|---------|
| Variable                                    | No. Firms | Obs    | Mean    | Std. Dev. | Median  |
| BrokerCheck Data:                           |           |        |         |           |         |
| Investment Advisory Firm                    | 4,178     | 38,627 | 23.1%   |           |         |
| Affiliated w/ Fin. Inst.                    | 4,178     | 38,627 | 52.7%   |           |         |
| Firm Age                                    | 4,178     | 38,627 | 15.15   | 13.34     | 12      |
| Owner/Officer Misconduct                    | 4,178     | 38,627 | 30.7%   |           |         |
| No. Business Lines                          | 4,178     | 38,627 | 5.79    | 4.57      | 4       |
| Number of Advisers                          | 4,178     | 38,627 | 170     | 1,212     | 10      |
| Firm Employee Misconduct (flow in one year) | 4,178     | 38,627 | 0.51%   | 3.36%     | 0.00%   |
| Firm Employee Misconduct (stock)            | 4,178     | 38,627 | 10.2%   | 17.1%     | 2.6%    |
| Form ADV Data:                              |           |        |         |           |         |
| Services Retail Clients                     | 405       | 1,136  | 0.86    |           |         |
| Number of Accounts                          | 441       | 1,554  | 24,535  | 1,065     | 133,446 |
| Compensation/Fee Structure                  |           |        |         |           |         |
| Assets Under Management                     | 441       | 1,554  | 94.1%   |           |         |
| Hourly                                      | 441       | 1,554  | 49.7%   |           |         |
| Fixed Fee                                   | 441       | 1,554  | 65.6%   |           |         |
| Commission                                  | 441       | 1,554  | 47.0%   |           |         |
| Performance                                 | 441       | 1,554  | 8.9%    |           |         |
| Other Data Sources:                         |           |        |         |           |         |
| No. Social Network Links                    | 1,696     | 16,159 | 2,365   | 22,693    | 47      |
| Total Assets (bn)                           | 75        | 824    | 31      | 61        | 13      |
| Total Revenue (mm)                          | 74        | 813    | 343     | 670       | 134     |
| Avg. Annual Payout                          | 73        | 802    | 201,819 | 101,163   | 195,818 |

Note: Table 1a displays the summary statistics corresponding to our panel of financial advisers over the period 2005-2015. Observations are adviser by year. We report the standard deviation and median for the non-dummy variables. Table 1b displays summary statistics of financial advisory firms. Observations reported in Table 1b are firm by year. The BrokerCheck data covers the period 2005-2015. Information on the number of business lines, investment advisory registration, and affiliations are as of 2015. Form ADV data covers the period 2011-2015. No. Social Network Links measures the number of individuals who follow a firm on a popular social media website as of May 2015. Data covering the asset, revenue, and average adviser payout/salary data are from a private industry survey as of 2014.

Table 2: Financial Adviser Disclosures and Misconduct

| Disclosure                              | Disclosure/Misconduct   |                      |
|---|-------------------------|----------------------|
|   | Flow of New Disclosures | Stock of Disclosures |
| <b>Misconduct Disclosures:</b>          |                         |                      |
| Customer Dispute - Settled              | 0.317%                  | 3.71%                |
| Employment Separation After Allegations | 0.183%                  | 0.98%                |
| Regulatory - Final                      | 0.096%                  | 1.23%                |
| Criminal - Final Disposition            | 0.025%                  | 2.05%                |
| Customer Dispute - Award/Judgment       | 0.017%                  | 0.57%                |
| Civil - Final                           | 0.003%                  | 0.03%                |
| Any Misconduct Related Disclosure       | 0.603%                  | 7.28%                |
| <b>Other Disclosures:</b>               |                         |                      |
| Financial - Final                       | 0.348%                  | 2.10%                |
| Customer Dispute - Denied               | 0.311%                  | 3.20%                |
| Judgment/Lien                           | 0.215%                  | 1.00%                |
| Customer Dispute - Closed-No Action     | 0.072%                  | 0.96%                |
| Financial - Pending                     | 0.058%                  | 0.20%                |
| Customer Dispute - Pending              | 0.057%                  | 0.28%                |
| Customer Dispute - Withdrawn            | 0.016%                  | 0.17%                |
| Criminal - Pending Charge               | 0.009%                  | 0.02%                |
| Investigation                           | 0.009%                  | 0.03%                |
| Regulatory - Pending                    | 0.004%                  | 0.01%                |
| Civil - Pending                         | 0.004%                  | 0.01%                |
| Customer Dispute - Final                | 0.002%                  | 0.02%                |
| Customer Dispute - Dismissed            | 0.001%                  | 0.01%                |
| Civil Bond                              | 0.001%                  | 0.02%                |
| Regulatory - On Appeal                  | 0.001%                  | 0.00%                |
| Criminal - On Appeal                    | 0.000%                  | 0.00%                |
| Civil - On Appeal                       | 0.000%                  | 0.00%                |
| <b>Any Disclosure</b>                   | <b>1.620%</b>           | <b>12.73%</b>        |

Note: Table 2 displays the incidence of disclosures and misconduct among financial advisers. Observations are adviser by year over the period 2005-2015. The column flow of new disclosures displays the share of observations in which the adviser received one or more of a given type of disclosure in a given year. The column stock of disclosures displays the share of observations in which the adviser either received or previously received one or more of a given type of disclosure.

Table 3: Misconduct Complaints, Products, and Settlements/Damages

| (a) Reasons for Complaint   |                 |            |  |  |
|-----------------------------|-----------------|------------|--|--|
| Reasons for Complaint       | Disclosure Type |            |  |  |
|                             | Misconduct      | Other Type |  |  |
| Unsuitable                  | 21.3%           | 31.1%      |  |  |
| Misrepresentation           | 17.7%           | 25.6%      |  |  |
| Unauthorized Activity       | 15.0%           | 10.6%      |  |  |
| Omission of Key Facts       | 11.6%           | 7.7%       |  |  |
| Fee/Commission Related      | 8.7%            | 7.4%       |  |  |
| Fraud                       | 7.9%            | 4.2%       |  |  |
| Fiduciary Duty              | 6.5%            | 4.5%       |  |  |
| Negligence                  | 5.8%            | 4.5%       |  |  |
| Risky Investments           | 3.7%            | 6.3%       |  |  |
| Churning/ Excessive Trading | 2.6%            | 2.7%       |  |  |
| Other                       | 42.5%           | 31.5%      |  |  |

| (b) Products     |                 |            |
|------------------|-----------------|------------|
| Product          | Disclosure Type |            |
|                  | Misconduct      | Other Type |
| Insurance        | 13.8%           | 15.2%      |
| Annuity          | 8.6%            | 18.6%      |
| Stocks           | 6.0%            | 6.3%       |
| Mutual Funds     | 4.6%            | 5.9%       |
| Bonds            | 1.9%            | 4.5%       |
| Options          | 1.2%            | 1.2%       |
| Other/Not Listed | 69.9%           | 55.0%      |

| (c) Settlements/Damages         |        |           |            |         |
|---------------------------------|--------|-----------|------------|---------|
| Variable                        | Obs    | Mean      | Std. Dev.  | Median  |
| Misconduct Related Disclosures: |        |           |            |         |
| Settlements/Damages Granted     | 35,406 | 551,471   | 9,300,282  | 40,000  |
| Settlements/Damages Requested   | 28,046 | 1,520,231 | 61,601,420 | 100,000 |
| Other Disclosures:              |        |           |            |         |
| Settlements/Damages Granted     | 751    | 6,152,410 | 50,738,600 | 45,478  |
| Settlements/Damages Requested   | 31,653 | 739,753   | 18,655,940 | 32,199  |

Table 3a displays the most frequently reported allegations corresponding to the disclosures that occurred over the period 2005-2015. We observe allegations for 91.9% of the misconduct related disclosures and 33.4% of the other types of disclosures. The allegation categories are not mutually exclusive. The "Other" category includes all other allegations/classifications that were reported with a frequency of less than 2%. Table 3b displays the most frequently reported financial products in the allegations. Over half of the allegations do not list a specific financial product. Table 3c displays the settlements/damages (in \$) that were granted and requested over the period 2005-2015. We observe the settlements/damages details for 45.8% of misconduct related disclosures and 0.6% of the other types of disclosures.

Table 4: Adviser Misconduct

|                           | (1)                | (2)                 | (3)                 |
|---------------------------|--------------------|---------------------|---------------------|
| Prior Misconduct          | 2.40***<br>(0.100) | 2.27***<br>(0.096)  | 1.90***<br>(0.074)  |
| Experience                |                    | 0.078***<br>(0.017) | 0.12***<br>(0.012)  |
| Exams and Qual. (Series): |                    |                     |                     |
| Inv. Adviser Exam (65/66) |                    | 0.31***<br>(0.031)  | 0.22***<br>(0.024)  |
| Sec. Agent St. Law (63)   |                    | 0.17***<br>(0.021)  | 0.13***<br>(0.018)  |
| Gen. Sec. Rep. (7)        |                    | 0.032<br>(0.033)    | 0.045*<br>(0.024)   |
| Inv. Co. Prod. Rep. (6)   |                    | 0.0043<br>(0.029)   | 0.028<br>(0.028)    |
| Gen. Sec. Principal (24)  |                    | 0.020<br>(0.030)    | 0.0033<br>(0.020)   |
| No. Other Qual.           |                    | -0.26**<br>(0.11)   | -0.28***<br>(0.075) |
| Year×Firm×County F.E.     |                    |                     | X                   |
| Observations              | 7,946,680          | 7,946,680           | 7,597,776           |
| R-squared                 | 0.006              | 0.007               | 0.092               |

Note: Table 4 displays the regression results for a linear probability model (eq. 1). The dependent variable measures the flow of new misconduct over a one year period and is a dummy variable indicating that the adviser received one or more misconduct disclosures in a given year. Coefficient units are percentage points. The independent variables Experience and No. Other Qual. are measured in tens of years and tens of qualifications. Observations are at the adviser by year level. Standard errors are in parentheses and are clustered by firm. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.10$ .

Table 5: Firms with the Highest Incidence of Misconduct

| Rank | Firm  | Firm CRD# | Misconduct | # Advisers |
|------|---|-----------|------------|------------|
| 1    | OPPENHEIMER & CO. INC.                      | 249       | 19.6%      | 2,275      |
| 2    | FIRST ALLIED SECURITIES, INC.               | 32444     | 17.7%      | 1,112      |
| 3    | WELLS FARGO ADVISORS FINANCIAL NETWORK, LLC | 11025     | 15.3%      | 1,797      |
| 4    | UBS FINANCIAL SERVICES INC.                 | 8174      | 15.1%      | 12,175     |
| 5    | CETERA ADVISORS LLC                         | 10299     | 14.4%      | 1,432      |
| 6    | SECURITIES AMERICA, INC.                    | 10205     | 14.3%      | 2,546      |
| 7    | NATIONAL PLANNING CORPORATION               | 29604     | 14.0%      | 1,760      |
| 8    | RAYMOND JAMES & ASSOCIATES, INC.            | 705       | 13.7%      | 5,495      |
| 9    | STIFEL, NICOLAUS & COMPANY, INCORPORATED    | 793       | 13.3%      | 4,008      |
| 10   | JANNEY MONTGOMERY SCOTT LLC                 | 463       | 13.3%      | 1,394      |
| 11   | MORGAN STANLEY                              | 149777    | 13.1%      | 23,618     |
| 12   | SAGEPOINT FINANCIAL, INC.                   | 133763    | 12.1%      | 2,063      |
| 13   | WELLS FARGO ADVISORS, LLC                   | 19616     | 12.1%      | 26,308     |
| 14   | FSC SECURITIES CORPORATION                  | 7461      | 11.6%      | 1,373      |
| 15   | PURSHE KAPLAN STERLING INVESTMENTS          | 35747     | 11.4%      | 1,224      |
| 16   | ROYAL ALLIANCE ASSOCIATES, INC.             | 23131     | 11.4%      | 1,975      |
| 17   | RAYMOND JAMES FINANCIAL SERVICES, INC.      | 6694      | 11.2%      | 5,176      |
| 18   | WOODBURY FINANCIAL SERVICES, INC.           | 421       | 10.9%      | 1,377      |
| 19   | AMERIPRISE FINANCIAL SERVICES, INC.         | 6363      | 10.4%      | 13,549     |
| 20   | INVEST FINANCIAL CORPORATION                | 12984     | 10.1%      | 1,425      |

Note: Tables 5 displays the firms in the U.S. with the highest employee misconduct rates as of May 2015. Firms are defined by their Central Registration Depository (CRD) number. Misconduct measures the percentage of advisers working for a firm that have been reprimanded for misconduct in the past. We restrict the set to the 100 firms with at least 1,000 advisers.

Table 6: Firm Employee Misconduct

|                                   | (1)                | (2)                  | (3)                  | (4)                  |
|-----------------------------------|--------------------|----------------------|----------------------|----------------------|
| Firm Employee Misconduct $_{t-1}$ | 0.40***<br>(0.023) | 0.36***<br>(0.024)   | 0.33***<br>(0.022)   | 0.30***<br>(0.030)   |
| Owner/Officer Misconduct          |                    | 0.082*<br>(0.043)    | 0.096**<br>(0.039)   | 0.22***<br>(0.053)   |
| No. advisers (millions)           |                    | 3.33*<br>(1.88)      | 3.43*<br>(2.01)      | 42.1*<br>(21.9)      |
| Investment Advisory Firm          |                    | 0.043<br>(0.044)     | 0.014<br>(0.039)     | -0.015<br>(0.065)    |
| Affiliated w/ Fin. Inst.          |                    | -0.083<br>(0.053)    | -0.082*<br>(0.045)   | -0.076<br>(0.053)    |
| Firm Age                          |                    | -0.0013<br>(0.00087) | 0.00046<br>(0.00095) | -0.0022<br>(0.0020)  |
| ln(Social Network Links+1)        |                    |                      |                      | -0.018**<br>(0.0078) |
| Other Firm Controls               |                    | X                    | X                    | X                    |
| Year F.E.                         |                    |                      | X                    | X                    |
| State F.E.                        |                    |                      | X                    | X                    |
| Observations                      | 34,415             | 34,415               | 34,415               | 14,447               |
| R-squared                         | 0.172              | 0.198                | 0.251                | 0.243                |

Note: Table 6 corresponds to the linear regression of the firm's employee misconduct rate in a given year on the firm's past employee misconduct rate and other covariates (eq. 2). The data consists of an unbalanced panel of the universe of 4,178 currently active (as of May 2015) financial advisory firms over the period 2005-2015. Observations are at the firm by year level. Firm Employee Misconduct is defined as the percentage of advisers currently working for a firm that received one or more misconduct disclosures in a given year. Coefficient units are percentage points. Firm Age is measured in tens of years. Other firm controls include the firm's formation type (corporation, limited liability, etc.) as well as whether or not it has a referral arrangement with other advisory firms. Each observation is weighted by the square root of the number of advisers in the firm. Standard errors are in parentheses and are clustered by firm. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.10$ .

Table 7: Labor Market Consequences of Misconduct

| (a) Job Turnover                      |               |            |  |  |  |  |
|---------------------------------------|---------------|------------|--|--|--|--|
|                                       | No Misconduct | Misconduct |  |  |  |  |
| Remain with the Firm                  | 81.3%         | 52.0%      |  |  |  |  |
| Leave the Firm                        | 18.7%         | 48.0%      |  |  |  |  |
| Conditional on Leaving the Firm:      |               |            |  |  |  |  |
| Leave the Industry                    | 47.7%         | 56.2%      |  |  |  |  |
| Join a Different Firm (within 1 year) | 52.3%         | 43.8%      |  |  |  |  |

| (b) Employment Separation           |           |           |           |        |        |         |
|-------------------------------------|-----------|-----------|-----------|--------|--------|---------|
|                                     | (1)       | (2)       | (3)       | (4)    | (5)    | (6)     |
| Misconduct                          | 29.3***   | 30.8***   | 24.4***   |        |        |         |
|                                     | (1.69)    | (1.62)    | (1.82)    |        |        |         |
| ln(Settlement)                      |           |           |           | 0.59   | 0.99** | 0.89*** |
|                                     |           |           |           | (0.48) | (0.47) | (0.24)  |
| Adviser Controls                    |           | X         | X         |        | X      | X       |
| Year×Firm×County F.E.               |           |           | X         |        |        |         |
| Year F.E.                           |           |           |           |        |        | X       |
| County F.E.                         |           |           |           |        |        | X       |
| Firm F.E.                           |           |           |           |        |        | X       |
| Observations                        | 7,278,974 | 7,278,974 | 6,954,542 | 25,083 | 25,083 | 23,958  |
| R-squared                           | 0.004     | 0.011     | 0.326     | 0.001  | 0.017  | 0.223   |
| Average employment separation rates | 18.9      | 18.9      | 19.0      | 27.4   | 27.4   | 27.3    |

| (c) Reemployment           |           |           |           |         |          |          |
|----------------------------|-----------|-----------|-----------|---------|----------|----------|
|                            | (1)       | (2)       | (3)       | (4)     | (5)      | (6)      |
| Misconduct                 | -8.47***  | -12.8***  | -9.59***  |         |          |          |
|                            | (2.48)    | (1.53)    | (1.10)    |         |          |          |
| ln(Settlement)             |           |           |           | -1.80** | -2.40*** | -2.87*** |
|                            |           |           |           | (0.75)  | (0.67)   | (0.49)   |
| Adviser Controls           |           | X         | X         |         | X        | X        |
| Year×Firm×County F.E.      |           |           | X         |         |          |          |
| Year F.E.                  |           |           |           |         |          | X        |
| County F.E.                |           |           |           |         |          | X        |
| Firm F.E.                  |           |           |           |         |          | X        |
| Observations               | 1,375,641 | 1,375,641 | 1,246,907 | 6,874   | 6,874    | 6,169    |
| R-squared                  | 0.000     | 0.125     | 0.373     | 0.005   | 0.076    | 0.326    |
| Average reemployment rates | 52.2      | 52.2      | 53.2      | 66.2    | 66.2     | 67.7     |

Note: Table 7a displays the average annual job turnover among financial advisers over the period 2005-2015. Leave the Industry is defined as an adviser's not being employed as a financial adviser for at least one year; Join a Different Firm is a dummy variable that takes the value of one if the adviser is employed at a different financial advisory firm within a year. The job transitions are broken down by the whether or not the adviser received a misconduct disclosure in the previous year.

Tables 7b and 7c measure the labor market consequences of misconduct by estimating linear probability models in eq. (3)-(6). The dependent variable in Table 7b is a dummy variable indicating whether or not a financial adviser left his firm (eq. 3 and 4). The dependent variable in Table 7c is a dummy variable indicating whether or not a financial adviser joined a new firm within one year (eq. 5 and 6). In Table 7c we restrict the sample to advisers who left their firm in a given year. In columns (4)-(6) of Tables 7b and 7c we restrict the sample to advisers who received misconduct disclosures in the previous year and for whom we observe settlement/damage amount paid. Coefficients are in units of percentage points. Other adviser controls include the adviser's industry experience, tests (series 6, 7, 63, 24 and investment adviser exam), and number of other qualifications. Observations are at the financial adviser by year level. Standard errors are in parentheses and are clustered by firm. \*\*\* p<0.01, \*\* p<0.05, \* p<0.10.

Table 8: Duration Out of the Financial Advisory Industry

|                        | (1)                 | (2)                 | (3)                 | (4)                 |
|------------------------|---------------------|---------------------|---------------------|---------------------|
| Misconduct             | 0.83***<br>(0.0064) | 0.83***<br>(0.0065) | 1.03***<br>(0.0080) | 1.03***<br>(0.0080) |
| Other Adviser Controls | X                   | X                   | X                   | X                   |
| Year F.E.              |                     | X                   |                     | X                   |
| Complete Spells        |                     |                     | X                   | X                   |
| Observations           | 1,357,046           | 1,357,046           | 758,870             | 758,870             |

Note: Table 8 estimates the relationship between misconduct and an adviser's duration out of the financial advisory industry, corresponding to a Cox proportional hazard model (eq. 7). Other adviser controls include the adviser's experience, tests (series 6, 7, 63, 24 and investment adviser exam), and number of other qualifications. The coefficients are reported in terms of proportional hazards. Observations are at the financial adviser by out of the industry spell level over the period 2005-2015. In columns (3)-(4) we restrict the data set to include only complete out of the industry spells where we observe the adviser found new employment in the industry. Robust standard errors are in parentheses. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.10$ .

Table 9: New Firm Characteristics

|                       | Avg. Payout           | No. Social Links      | Misc. Rate (pp)    | Firm Size            | Assets (\$bn)       | Rev. (\$mm)     |
|-----------------------|-----------------------|-----------------------|--------------------|----------------------|---------------------|-----------------|
| Misconduct            | -14,690***<br>(3,567) | -12,477***<br>(3,361) | 0.53***<br>(0.058) | -1,898***<br>(230.2) | -36.76***<br>(4.82) | -391***<br>(41) |
| Orig Firm x Year F.E. | X                     | X                     | X                  | X                    | X                   | X               |
| Observations          | 69,050                | 32,586                | 456,947            | 456,947              | 75,392              | 75,087          |
| R-squared             | 0.559                 | 0.145                 | 0.290              | 0.467                | 0.332               | 0.503           |

Note: Table 9 displays the characteristics of new firms joined by advisers who switched firms as a function of whether or not the adviser was reprimanded for misconduct in the year prior to the job transition (eq. 8). No. Social Network Links measures the number of individuals who follow a firm on a popular social media website as of May 2015. Firm Employee Misconduct (Misc. Rate) measures the share of financial advisers working at a firm that were reprimanded for misconduct in a given year. Observations are adviser by job transition for which the adviser found a job within a year. We restrict the data to observations in which advisers who were and were not reprimanded for misconduct leave a given firm in a given year. Standard errors are in parentheses and are clustered by firm. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.10$ .

Table 10: Firm Differences in Misconduct Tolerance

| (a) Employment Separation                    |                    |                    |                    |
|--|--------------------|--------------------|--------------------|
|  | (1)                | (2)                | (3)                |
| Misconduct                                   | 31.2***<br>(1.89)  | 33.1***<br>(1.74)  | 27.3***<br>(1.84)  |
| Firm Employee Misconduct                     | 2.79***<br>(0.41)  | 3.06***<br>(0.37)  |                    |
| Firm Employee Misconduct $\times$ Misconduct | -2.84***<br>(0.41) | -3.10***<br>(0.37) | -1.32***<br>(0.11) |
| Adviser Controls                             |                    | X                  | X                  |
| Year $\times$ Firm $\times$ County F.E.      |                    |                    | X                  |
| Observations                                 | 7,278,974          | 7,278,974          | 6,954,542          |
| R-squared                                    | 0.009              | 0.017              | 0.326              |

| (b) Hiring                        |                    |                    |                    |
|-----------------------------------|--------------------|--------------------|--------------------|
|                                   | (1)                | (2)                | (3)                |
| Firm Employee Misconduct $_{t-1}$ | 0.72***<br>(0.079) | 0.69***<br>(0.081) | 0.68***<br>(0.080) |
| Firm Controls                     | X                  | X                  | X                  |
| Year F.E.                         |                    | X                  | X                  |
| State F.E.                        |                    |                    | X                  |
| Observations                      | 18,628             | 18,628             | 18,628             |
| R-squared                         | 0.087              | 0.093              | 0.102              |

Note: Table 10a examines whether firms which employ more advisers with misconduct records are more tolerant of misconduct in their separation decisions. It presents results corresponding to a linear probability model (eq. 9). Observations are at the financial adviser by year level over the period 2005-2015. The coefficients are in units of percentage points. Firm Employee Misconduct measures the share of financial advisers working at a firm that were reprimanded for misconduct in a given year. Firm Employee Misconduct is in units of percentage points. Other adviser controls include the adviser's experience, tests (series 6, 7, 63, 24 and investment adviser exam), and number of other qualifications. Standard errors are in parentheses and are clustered by firm.

Table 10b examines whether firms which employ more advisers with misconduct records are more tolerant of misconduct in their hiring decisions by presenting estimates from (eq. 10). Observations are at the firm by year level where we restrict the data set those observations where the firm hired new advisers. The data consists of an unbalanced panel of the universe of 4,178 currently active financial advisory firms over the period 2005-2015 was of May 2015. The dependent variable is the percentage of new hires made by a firm who were reprimanded for misconduct in the previous year. The coefficient units are in percentage points. Firm controls include: the number of advisers, the firm's formation type (corporation, limited liability, etc.), the firm's age, whether any owner/officers have a record of misconduct, whether the firm is an investment advisory firm, whether the firm is affiliated with a financial institution, and whether the firm has a referral arrangement with other advisory firms. Each observation is weighted by the square root of the number of advisers in the firm. Standard errors are in parentheses and are clustered by firm. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.10$ .

Table 11: Firm Employee Misconduct

|                            | Firm Employee Misconduct   |                   |                               |                    |
|----------------------------|----------------------------|-------------------|-------------------------------|--------------------|
|                            | Stock of Misconduct<br>(1) | (2)               | Flow of New Misconduct<br>(3) | (4)                |
| Retail Investors           | 3.43**<br>(1.56)           | 4.23***<br>(1.39) | 0.32**<br>(0.15)              | 0.21*<br>(0.12)    |
| Number of Accts (millions) | 0.93<br>(1.31)             | 5.01***<br>(1.38) | 0.085<br>(0.082)              | -0.056<br>(0.16)   |
| Compensation Structure:    |                            |                   |                               |                    |
| Assets Under Management    | 0.37<br>(1.23)             | 0.31<br>(0.97)    | 0.14<br>(0.12)                | 0.11<br>(0.11)     |
| Hourly                     | 1.99<br>(1.32)             | 2.07**<br>(0.98)  | 0.15**<br>(0.064)             | 0.18***<br>(0.062) |
| Fixed Fee                  | -0.016<br>(1.16)           | -1.16<br>(1.03)   | -0.0051<br>(0.12)             | 0.012<br>(0.13)    |
| Commission                 | 3.13***<br>(0.74)          | 2.79***<br>(0.72) | 0.012<br>(0.078)              | 0.022<br>(0.059)   |
| Performance                | -1.64<br>(1.13)            | 0.77<br>(1.41)    | 0.22<br>(0.17)                | 0.20*<br>(0.12)    |
| Firm Controls              |                            | X                 |                               | X                  |
| Year F.E.                  |                            | X                 |                               | X                  |
| State F.E.                 |                            | X                 |                               | X                  |
| Observations               | 1,136                      | 1,125             | 1,136                         | 1,125              |
| R-squared                  | 0.356                      | 0.464             | 0.084                         | 0.184              |

Note: Table 11 examines whether firms who service less sophisticated (retail) customers have higher shares of advisers with misconduct records. It displays regression results corresponding to (eq. 11). Observations are at the firm by year level over the period 2011-2014 for an unbalanced panel of 405 investment advisory firms. In columns (1) and (2) we measure the firm employee misconduct rate as the stock of misconduct: the percentage of advisers currently working for a firm that have ever been reprimanded for misconduct. In columns (3) and (4) we measure the firm employee misconduct rate as the flow of new misconduct: the percentage of advisers currently working for a firm that are reprimanded for misconduct in a given year. Coefficients are in units of percentage points. Firm controls include the firm size (no. advisers), number of states the firm operates in, and the age of the firm. Each observation is weighted by the square root of the number of advisers in the firm. Standard errors are in parentheses and are clustered by firm. \*\*\* p<0.01, \*\* p<0.05, \* p<0.10.

Table 12: Counties with the Highest and Lowest Rates of Misconduct

| (a) % of advisers with Misconduct Records |                        |            |            | (b) % of advisers with Misconduct Records |                 |            |            |
|---|------------------------|------------|------------|---|-----------------|------------|------------|
| Rank                                      | County                 | Misc. Rate | # Advisers | Rank                                      | County          | Misc. Rate | # Advisers |
| 1   | Madison, NY            | 32.1%      | 131        | 1   | Franklin, PA    | 2.6%       | 114        |
| 2   | Indian River, FL       | 19.2%      | 282        | 2   | Saline, KS      | 2.7%       | 112        |
| 3   | Guaynabo Municipio, PR | 19.1%      | 126        | 3   | Cerro Gordo, IA | 2.7%       | 112        |
| 4   | Monterey, CA           | 18.4%      | 397        | 4   | Kenton, KY      | 2.9%       | 1,991      |
| 5   | Martin, FL             | 18.4%      | 357        | 5   | Washington, VT  | 3.0%       | 197        |
| 6   | Palm Beach, FL         | 18.1%      | 5,278      | 6   | Bronx, NY       | 3.1%       | 226        |
| 7   | Richmond, NY           | 17.7%      | 436        | 7   | Rutherford, TN  | 3.1%       | 161        |
| 8   | Suffolk, NY            | 17.3%      | 4,136      | 8   | Stearns, MN     | 3.3%       | 491        |
| 9   | Bay, FL                | 17.0%      | 106        | 9   | Ottawa, MI      | 3.5%       | 312        |
| 10  | Lee, FL                | 16.8%      | 853        | 10  | Boone, MO       | 3.8%       | 159        |

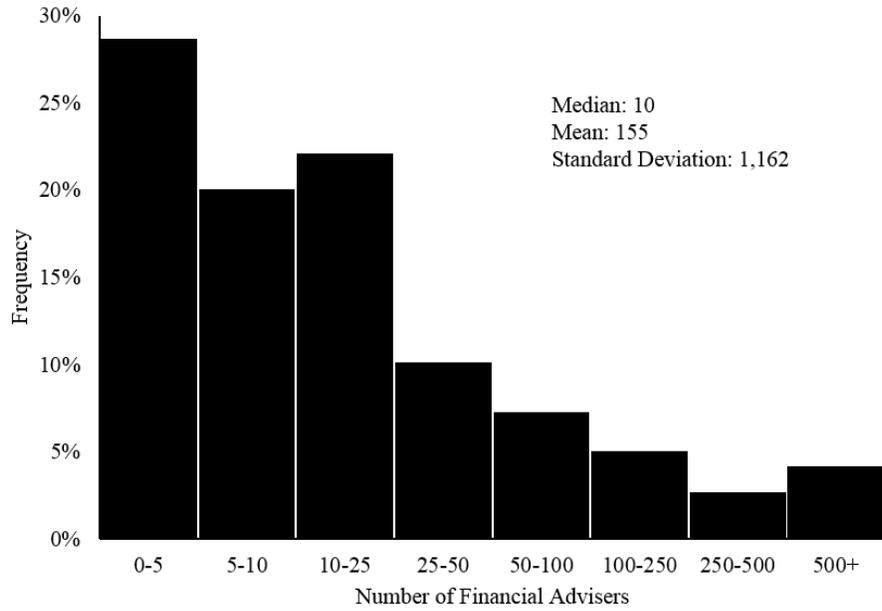
(c) County Misconduct

|                   | County Misconduct   |                    |                        |                    |
|-------------------|---------------------|--------------------|------------------------|--------------------|
|                   | Stock of Misconduct |                    | Flow of New Misconduct |                    |
|                   | (1)                 | (2)                | (3)                    | (4)                |
| ln(pop) -         | 0.016<br>(0.23)     | 0.21<br>(0.14)     | 0.0011<br>(0.029)      | 0.034<br>(0.021)   |
| ln(inc)           | 6.78***<br>(1.29)   | 8.41***<br>(1.81)  | 0.60***<br>(0.17)      | 1.03***<br>(0.18)  |
| Pct Rural         | -5.90***<br>(2.01)  | -4.09**<br>(1.83)  | -0.62**<br>(0.25)      | -0.47**<br>(0.23)  |
| Pct College       | -20.5***<br>(3.13)  | -18.5***<br>(3.46) | -1.91***<br>(0.26)     | -2.20***<br>(0.34) |
| Pct 65 or Older   | 34.5***<br>(9.43)   | 37.8***<br>(7.11)  | 3.38***<br>(1.04)      | 2.97***<br>(0.84)  |
| Labor Force Part. | -9.50<br>(7.24)     | -5.52<br>(6.20)    | -2.17***<br>(0.80)     | -1.95***<br>(0.75) |
| Year F.E.         |                     | X                  |                        | X                  |
| State F.E.        |                     | X                  |                        | X                  |
| Observations      | 2,607               | 2,607              | 2,607                  | 2,607              |
| R-squared         | 0.453               | 0.640              | 0.222                  | 0.397              |

Note: Table 12a panels (a) and (b) display the counties in the U.S. with the highest and lowest misconduct rates as of May 2015. The county misconduct rate is defined in terms of the stock of misconduct: the percentage of financial advisers in a county that have ever had a misconduct record. We restrict the set of counties to those with at least 100 advisers.

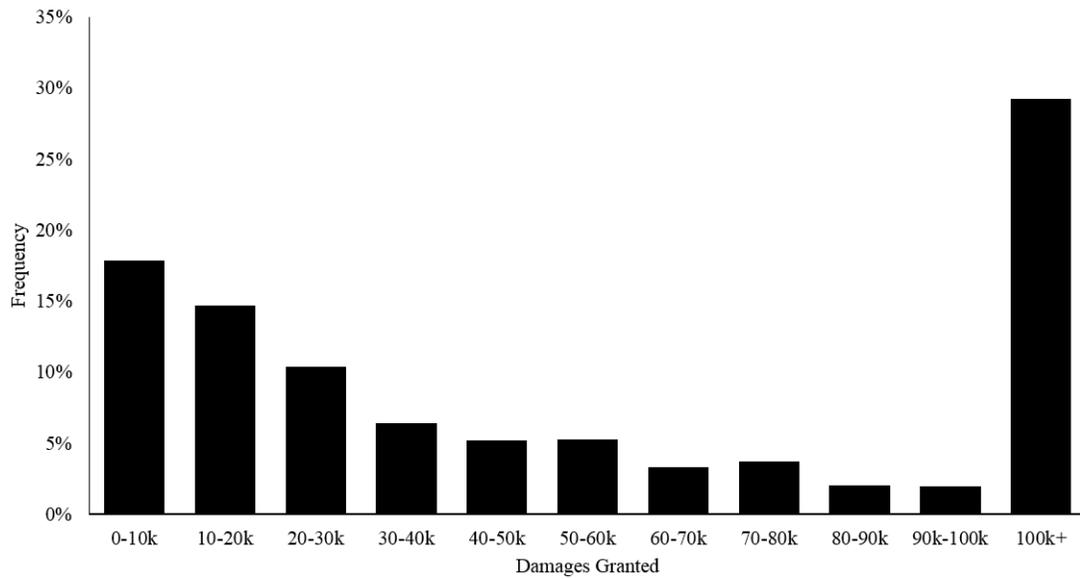
Table 12c examines which county characteristics predict misconduct, corresponding to (eq. 12). Observations are at the county by year level over the period 2010-2013. We restrict the data set to those counties with more than 50 advisers for which demographic data is available from the American Community Survey. In columns (1) and (2) we measure the county misconduct rate as the stock of misconduct: the percentage of advisers currently in a county that have been reprimanded for misconduct at or prior to the given year. In columns (3) and (4) we measure the county misconduct rate as the flow of new misconduct: the percentage of advisers currently in a county that were reprimanded for misconduct in the given year. Coefficients are in units of percentage points. The independent variables Pct Rural, Pct College, and Pct 65 or Older are measured on the scale 0-1. Each observation is weighted by the square root of the number of advisers in the county. Standard errors are in parentheses and are clustered by county. \*\*\* p<0.01, \*\* p<0.05, \* p<0.10.

Figure 1: Size Distribution of Financial Advisory Firms



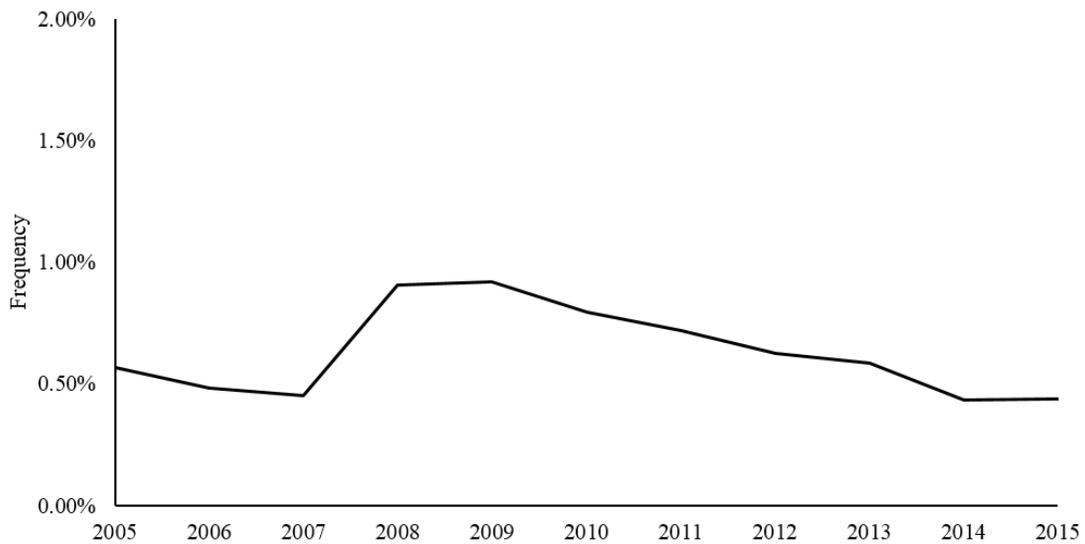
Note: Figure 1 displays the size distribution of US financial advisory firms in terms of the number of registered advisers working at each firm in May 2015. Firms are defined by their Central Registration Depository (CRD) number.

Figure 2: Distribution of Settlements/Damages



Note: Figure 2 displays the frequency of settlements/damages that were granted over the period 2005-2015.

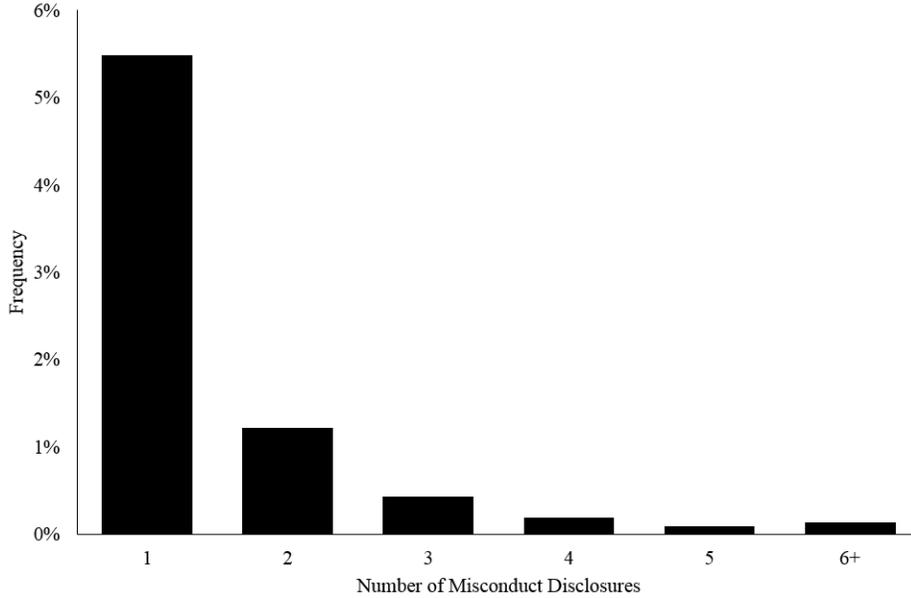
Figure 3: Misconduct over Time



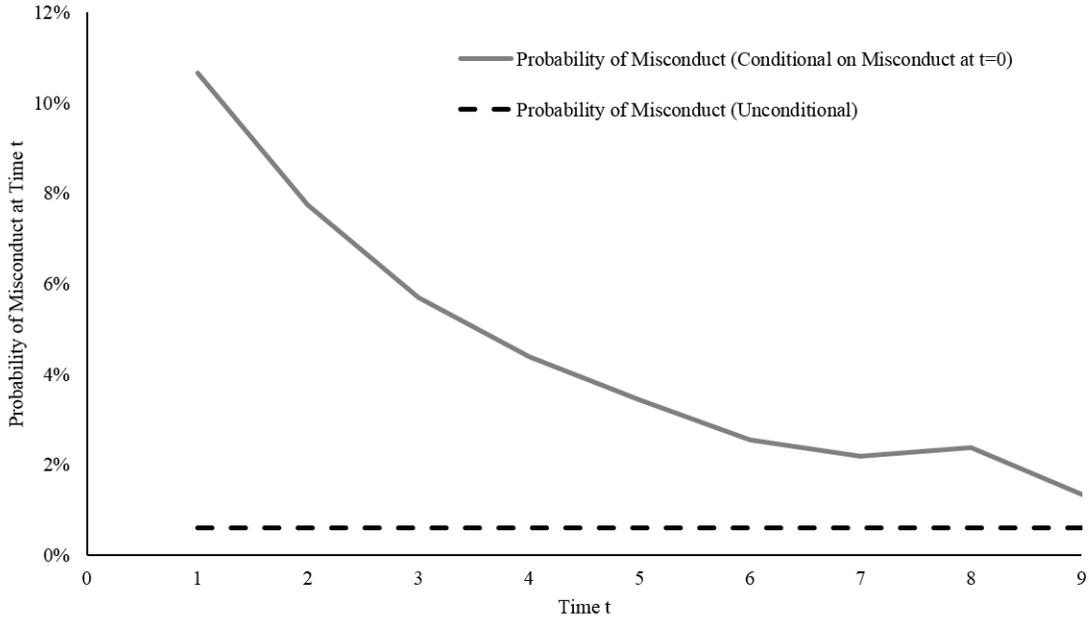
Note: Figure 3 displays the percentage of financial advisers who received one or more misconduct disclosures in the given year over the period 2005-2015.

Figure 4: Misconduct Frequency

(a) Distribution of Misconduct



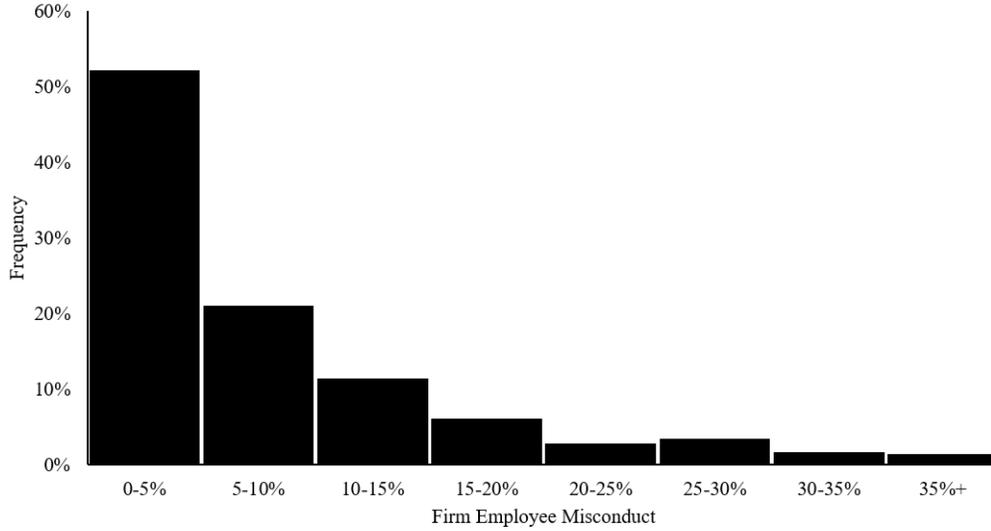
(b) Repeat Offenders



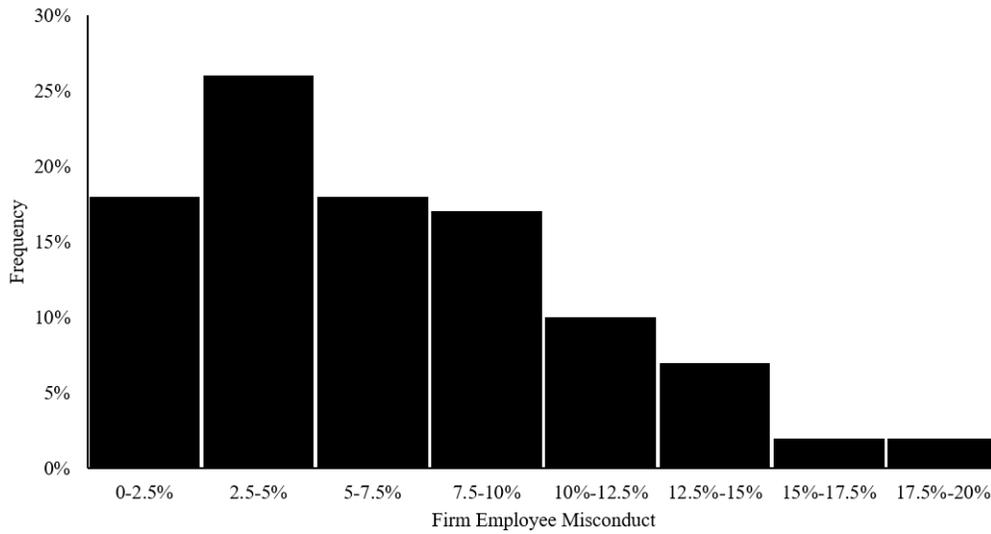
Note: Figure 4a displays the percentage of advisers registered in May 2015 who have misconduct records and the number of misconduct disclosures. The gray line in Figure 4b displays the conditional probability of a new misconduct record at time  $t$  given the adviser had a new misconduct record at time  $t = 0$ . The black dashed line displays the unconditional probability of a new misconduct record (0.60%). We construct the gray series by calculating the percentage of advisers who received misconduct disclosures at time  $t$  (for  $t = 1, 2, \dots, 9$ ) given that the adviser received a misconduct disclosure at time  $t = 0$ . We examine the set of financial advisers who were active for at least this period of time  $t$  in our sample. So, to estimate the probability an adviser receives a new misconduct disclosure 9 years after previously receiving a misconduct disclosure, we calculate the conditional probabilities among the set of financial advisers who were active in both 2005 and 2014 and/or 2006 and 2015. Therefore, the sample size changes as  $t$  changes from 1 to 10 years.

Figure 5: Distribution of Misconduct Across Firms

(a) Firms with at Least 100 Employees



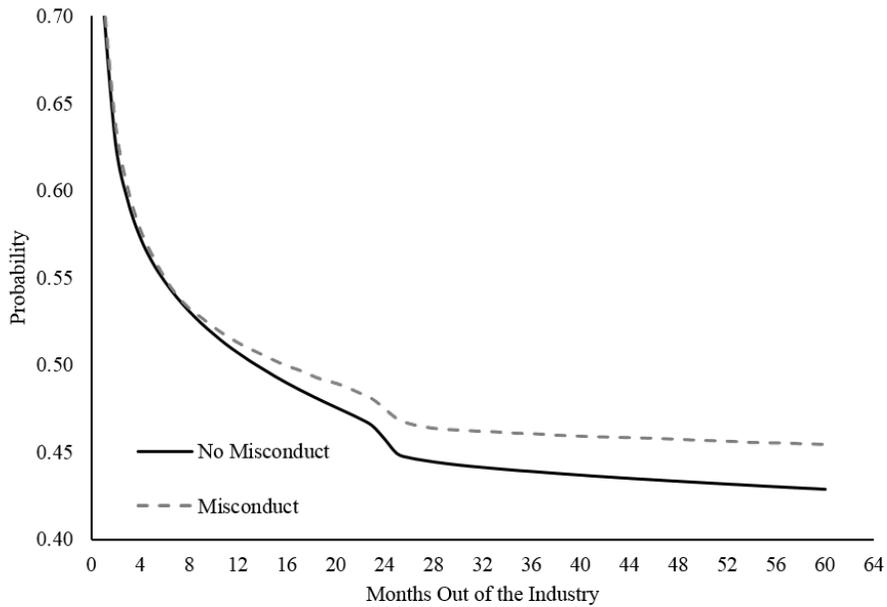
(b) Firms with at Least 1,000 Employees



Note: Figures 5a and 5b display the distribution of firms in terms of the percentage of advisers working for the firm with a prior misconduct record in May 2015. Panel (a) restricts the sample to firms with at least 100 advisers. Panel (b) restricts the sample to firms with at least 1,000 advisers.

Figure 6: Duration Out of the Industry

(a) Out of the Industry Survival Function



(b) Out of the Industry Survival Function - Conditional on Finding a Job in the Industry

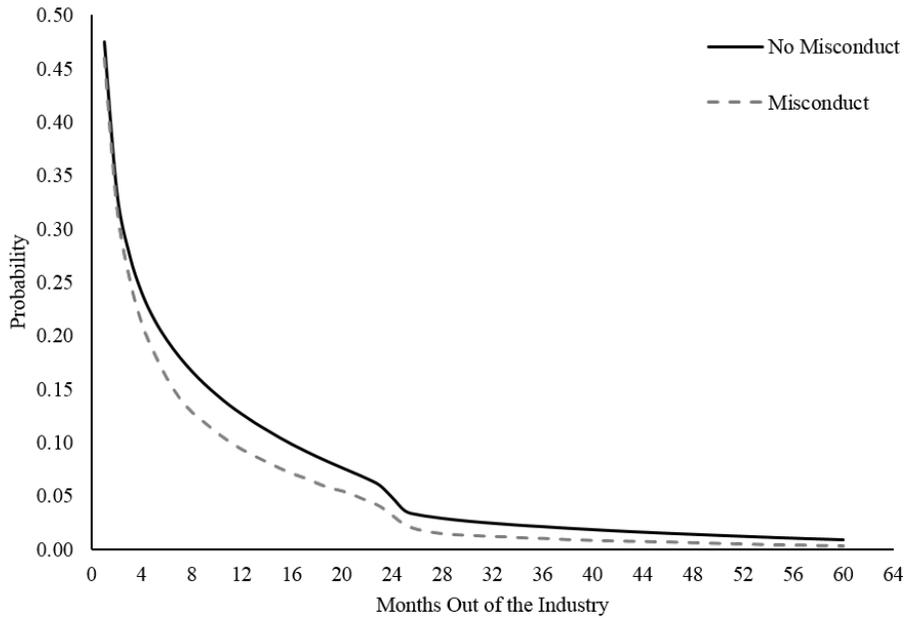


Figure 6a displays the out of the financial advisory industry survival function for all 1.35mm out of the industry spells over the period 2005-2015. The dashed gray (solid black) line plots the out of the industry survival function for advisers who (do not) have a new record misconduct in the twelve months prior to the start of their out of the industry spell. Figure 6b is constructed using only complete out of the industry spells (760,000 observations).

Figure 7: Financial Adviser Misconduct Across U.S. Counties



Note: Figure 7 displays the percentage of advisers who have a record of misconduct, the county misconduct rate, in May 2015. Colors denote the quartiles of the distribution.

# Appendix

## Disclosure Definitions<sup>34</sup>

**Civil-Final:** This type of disclosure event involves (1) an injunction issued by a court in connection with investment-related activity, (2) a finding by a court of a violation of any investment-related statute or regulation, or (3) an action brought by a state or foreign financial regulatory authority that is dismissed by a court pursuant to a settlement agreement.

**Civil - Pending:** This type of disclosure event involves a pending civil court action that seeks an injunction in connection with any investment-related activity or alleges a violation of any investment-related statute or regulation.

**Customer Dispute - Award/Judgment:** This type of disclosure event involves a final, consumer-initiated, investment-related arbitration or civil suit containing allegations of sales practice violations against the adviser that resulted in an arbitration award or civil judgment for the customer.

**Customer Dispute - Settled:** This type of disclosure event involves a consumer-initiated, investment-related complaint, arbitration proceeding or civil suit containing allegations of sales practice violations against the adviser that resulted in a monetary settlement to the customer.

**Customer Dispute - Closed-No Action/Withdrawn/Dismissed/Denied/Final:** This type of disclosure event involves (1) a consumer-initiated, investment-related arbitration or civil suit containing allegations of sales practice violations against the individual adviser that was dismissed, withdrawn, or denied; or (2) a consumer-initiated, investment-related written complaint containing allegations that the adviser engaged in sales practice violations resulting in compensatory damages of at least \$5,000, forgery, theft, or misappropriation, or conversion of funds or securities, which was closed without action, withdrawn, or denied.

**Customer Dispute - Pending:** This type of disclosure event involves (1) a pending consumer-initiated, investment-related arbitration or civil suit that contains allegations of sales practice violations against the adviser; or (2) a pending, consumer-initiated, investment related written complaint containing allegations that the adviser engaged in, sales practice violations resulting in compensatory damages of at least \$5,000, forgery, theft, or misappropriation, or conversion of funds or securities.

**Employment Separation After Allegations:** This type of disclosure event involves a situation where the adviser voluntarily resigned, was discharged, or was permitted to resign after being accused of (1) violating investment-related statutes, regulations, rules or industry standards of conduct; (2) fraud or the wrongful taking of property; or (3) failure to supervise in connection with investment-related statutes, regulations, rules, or industry standards of conduct.

<sup>34</sup>Definitions as per <http://brokercheck.finra.org/>

**Judgment/Lien:** This type of disclosure event involves an unsatisfied and outstanding judgments or liens against the adviser.

**Criminal - Final Disposition:** This type of disclosure event involves a criminal charge against the adviser that has resulted in a conviction, acquittal, dismissal, or plea. The criminal matter may pertain to any felony or certain misdemeanor offenses, including bribery, perjury, forgery, counterfeiting, extortion, fraud, and wrongful taking of property.

**Financial - Final:** This type of disclosure event involves a bankruptcy, compromise with one or more creditors, or Securities Investor Protection Corporation liquidation involving the adviser or an organization the adviser controlled that occurred within the last 10 years.

**Financial - Pending:** This type of disclosure event involves a pending bankruptcy, compromise with one or more creditors, or Securities Investor Protection Corporation liquidation involving the adviser or an organization the adviser controlled that occurred within the last 10 years.

**Investigation:** This type of disclosure event involves any ongoing formal investigation by an entity such as a grand jury state or federal agency, self-regulatory organization or foreign regulatory authority. Subpoenas, preliminary or routine regulatory inquiries, and general requests by a regulatory entity for information are not considered investigations and therefore are not included in a BrokerCheck report.

**Regulatory - Final:** This type of disclosure event may involves (1) a final, formal proceeding initiated by a regulatory authority (e.g., a state securities agency, self-regulatory organization, federal regulatory such as the Securities and Exchange Commission, foreign financial regulatory body) for a violation of investment-related rules or regulations; or (2) a revocation or suspension of a adviser's authority to act as an attorney, accountant, or federal contractor.

**Civil Bond:** This type of disclosure event involves a civil bond for the adviser that has been denied, paid, or revoked by a bonding company.

**Criminal - On Appeal:** This type of disclosure event involves a conviction for any felony or certain misdemeanor offenses, including bribery, perjury, forgery, counterfeiting, extortion, fraud, and wrongful taking of property that is currently on appeal.

**Criminal - Pending Charge:** This type of disclosure event involves a formal charge for a crime involving a felony or certain misdemeanor offenses, including bribery, perjury, forgery, counterfeiting, extortion, fraud, and wrongful taking of property that is currently pending.

**Regulatory - On Appeal:** This type of disclosure event may involves (1) a formal proceeding initiated by a regulatory authority (e.g., a state securities agency, self-regulatory organization, federal regulator such as the Securities and Exchange Commission, foreign financial regulatory body) for a violation of

investment-related rules or regulations that is currently on appeal; or (2) a revocation or suspension of a adviser's authority to act as an attorney, accountant, or federal contractor that is currently on appeal.

**Regulatory - Pending:** This type of disclosure event involves a pending formal proceeding initiated by a regulatory authority (e.g., a state securities agency, self-regulatory organization, federal regulatory agency such as the Securities and Exchange Commission, foreign financial regulatory body) for alleged violations of investment-related rules or regulations.

**Civil - On Appeal:** This type of disclosure event involves an injunction issued by a court in connection with investment-related activity or a finding by a court of a violation of any investment-related statute or regulation that is currently on appeal.

Table A1: Distribution of Financial Advisers Across the US

| (a) Total Number of Advisers |                        |        | (b) Advisers Per Capita |                          |               |
|------------------------------|------------------------|--------|-------------------------|--------------------------|---------------|
| Variable                     | Description            |        | Rank                    | County                   | Advisers P.C. |
| 1                            | New York County, NY    | 89,704 | 1                       | McLean County, IL        | 0.074         |
| 2                            | Cook County, IL        | 18,620 | 2                       | New York County, NY      | 0.055         |
| 3                            | Los Angeles County, CA | 15,969 | 3                       | St. Louis city, MO       | 0.022         |
| 4                            | McLean County, IL      | 12,979 | 4                       | Kenton County, KY        | 0.012         |
| 5                            | Maricopa County, AZ    | 11,032 | 5                       | Suffolk County, MA       | 0.012         |
| 6                            | Harris County, TX      | 9,429  | 6                       | Chester County, PA       | 0.011         |
| 7                            | Hennepin County, MN    | 9,407  | 7                       | San Francisco County, CA | 0.009         |
| 8                            | Suffolk County, MA     | 9,054  | 8                       | Mecklenburg County, NC   | 0.008         |
| 9                            | Mecklenburg County, NC | 8,564  | 9                       | Denver County, CO        | 0.008         |
| 10                           | Orange County, CA      | 8,475  | 10                      | Arapahoe County, CO      | 0.008         |

(c) Advisers Per Capita vs. County Demographics

|                   | Financial Advisers Per Capita |                    |
|-------------------|-------------------------------|--------------------|
|                   | (1)                           | (2)                |
| ln(pop)           | 0.62***<br>(0.24)             | 0.59***<br>(0.22)  |
| ln(inc)           | -2.09***<br>(0.54)            | -2.84***<br>(0.85) |
| Pct Rural         | 0.26<br>(0.74)                | -0.031<br>(0.61)   |
| Pct College       | 11.2***<br>(3.45)             | 12.5***<br>(4.09)  |
| Pct 65 or Older   | 3.72*<br>(2.12)               | 5.15<br>(3.63)     |
| Labor Force Part. | 5.83***<br>(1.91)             | 3.32**<br>(1.64)   |
| Year F.E.         |                               | X                  |
| State F.E.        |                               | X                  |
| Observations      | 3,277                         | 3,277              |
| R-squared         | 0.121                         | 0.157              |

Note: Tables A1a and A1b display the counties in the U.S. with the greatest number of total advisers and greatest number of advisers per capita as of May 2015. Advisers per capita is calculated using population data from the 2013 American Community Survey (ACS); therefore the ranking of advisers per capita is restricted to the 824 counties covered in the ACS.

Table A1c displays the regression results corresponding to the regression of the number of financial advisers per capita on a set of county covariates. The dependent variable is measured as the number of financial advisers in a county per 1,000 individuals. The independent variables Pct Rural, Pct College, and Pct 65 or Older are measured on the scale 0-1. Observations are at the county by year level over the period 2010-2013. We restrict the data set to those counties for which demographic data is available from the ACS. Standard errors are in parenthesis and are clustered by county. \*\*\* p<0.01, \*\* p<0.05, \* p<0.10.

Table A2: Largest Financial Advisory Firms

| Rank | Firm   | Firm CRD# | No. Advisers |
|------|--|-----------|--------------|
| 1    | MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED | 7691      | 32,107       |
| 2    | WELLS FARGO ADVISORS, LLC                          | 19616     | 26,308       |
| 3    | J.P. MORGAN SECURITIES LLC                         | 79        | 26,251       |
| 4    | MORGAN STANLEY                                     | 149777    | 23,618       |
| 5    | LPL FINANCIAL LLC                                  | 6413      | 18,093       |
| 6    | PFS INVESTMENTS INC.                               | 10111     | 17,700       |
| 7    | EDWARD JONES                                       | 250       | 16,750       |
| 8    | STATE FARM VP MANAGEMENT CORP.                     | 43036     | 15,089       |
| 9    | AMERIPRISE FINANCIAL SERVICES, INC.                | 6363      | 13,549       |
| 10   | FIDELITY BROKERAGE SERVICES LLC                    | 7784      | 12,697       |

Note: Table A2 displays the ten largest firms in terms of the number of advisers as of May 2015. Firms are defined by their Central Registration Depository (CRD) number.

Table A3: Misconduct Per Employee Across Industries (2010)

| State           | Adviser Misconduct |                     | Medical Malpractice | Public Corruption |
|-----------------|--------------------|---------------------|---------------------|-------------------|
|                 | All Advisers       | Investment Advisers |                     |                   |
| New York        | 0.74%              | 1.36%               | 2.04%               | 0.00%             |
| California      | 1.24%              | 1.66%               | 0.96%               | 0.00%             |
| Illinois        | 0.72%              | 0.97%               | 0.95%               | 0.01%             |
| Texas           | 0.79%              | 0.86%               | 0.99%               | 0.00%             |
| Florida         | 1.60%              | 1.94%               | 1.71%               | 0.01%             |
| New Jersey      | 0.98%              | 1.36%               | 1.75%               | 0.01%             |
| Pennsylvania    | 0.84%              | 1.18%               | 2.05%               | 0.01%             |
| Ohio            | 1.03%              | 0.98%               | 0.77%               | 0.01%             |
| Massachusetts   | 0.83%              | 1.44%               | 0.84%               | 0.01%             |
| North Carolina  | 0.56%              | 0.85%               | 0.59%               | 0.00%             |
| <b>Total US</b> | <b>0.97%</b>       | <b>1.35%</b>        | <b>1.20%</b>        | <b>0.00%</b>      |

Note: Table A3 displays the incidence of misconduct, medical malpractice and public corruption per employee as of 2010 among the ten states with the highest level of misconduct related disclosures as of 2010. Column (1) displays the share of advisers in 2010 in each state that received misconduct disclosures. Column (2) displays the share of financial advisers in 2010 that were disciplined for misconduct among those advisers who hold a Series 65 or 66 license (investment advisers). Column (3) displays the number of medical malpractice cases per doctor. Column (4) displays the number of public corruption cases per public employee. Sources: (i) AAMC 2011 State Physician Workforce Data Book and US Department of Health & Human Services National Practitioner Data Bank and (ii) Report to Congress on the Activities and Operations of the Public Integrity Section for 2012 and U.S. Bureau of Labor Statistics.

Table A4: Firms with the Lowest Incidence of Misconduct

| Rank | Firm                                       | Firm CRD# | Misconduct | # Advisers |
|------|--|-----------|------------|------------|
| 1    | MORGAN STANLEY & CO. LLC                   | 8209      | 0.79%      | 3,807      |
| 2    | GOLDMAN, SACHS & CO.                       | 361       | 0.88%      | 7,380      |
| 3    | BNP PARIBAS SECURITIES CORP.               | 15794     | 1.17%      | 1,109      |
| 4    | SUNTRUST ROBINSON HUMPHREY, INC.           | 6271      | 1.25%      | 1,040      |
| 5    | BLACKROCK INVESTMENTS, LLC                 | 38642     | 1.39%      | 1,442      |
| 6    | UBS SECURITIES LLC                         | 7654      | 1.51%      | 1,785      |
| 7    | JEFFERIES LLC                              | 2347      | 1.67%      | 1,676      |
| 8    | PRUDENTIAL INV. MGMT SERVICES LLC          | 18353     | 1.70%      | 1,234      |
| 9    | WELLS FARGO SECURITIES, LLC                | 126292    | 1.70%      | 2,876      |
| 10   | PERSHING LLC                               | 7560      | 1.72%      | 1,049      |
| 11   | BARCLAYS CAPITAL INC.                      | 19714     | 1.86%      | 3,717      |
| 12   | T. ROWE PRICE INVESTMENT SERVICES, INC.    | 8348      | 1.90%      | 1,741      |
| 13   | VANGUARD MARKETING CORPORATION             | 7452      | 2.11%      | 5,777      |
| 14   | NATIONAL FINANCIAL SERVICES LLC            | 13041     | 2.12%      | 1,177      |
| 15   | CREDIT SUISSE SECURITIES (USA) LLC         | 816       | 2.20%      | 3,733      |
| 16   | GWFS EQUITIES, INC.                        | 13109     | 2.21%      | 2,078      |
| 17   | NATIONWIDE INVESTMENT SERVICES CORPORATION | 7110      | 2.29%      | 2,011      |
| 18   | JACKSON NATIONAL LIFE DISTRIBUTORS LLC     | 40178     | 2.32%      | 1,034      |
| 19   | M&T SECURITIES, INC.                       | 17358     | 2.64%      | 1,439      |
| 20   | USAA FINANCIAL ADVISORS, INC.              | 129035    | 2.81%      | 1,672      |

Note: Table A4 displays the firms in the U.S. with the lowest employee misconduct rates as of May 2015. Firms are defined by their Central Registration Depository (CRD) number. Misconduct is defined as the percentage of advisers working for a firm that have been reprimanded for misconduct in the past. We restrict the set to the 100 firms with at least 1,000 advisers.

Table A5: New Firm Characteristics

|                       | Avg. Payout          | No. Social Links      | Misc. Rate (pp)    | Firm Size            | Assets (\$bn)   | Rev. (\$mm)      |
|-----------------------|----------------------|-----------------------|--------------------|----------------------|-----------------|------------------|
| Misconduct            | -10,379**<br>(5,011) | -12,542***<br>(3,581) | 0.50***<br>(0.082) | -1,498***<br>(340.8) | -8.37<br>(6.16) | -134**<br>(54.7) |
| Year×Firm×County F.E. | X                    | X                     | X                  | X                    | X               | X                |
| Observations          | 19,620               | 5,238                 | 162,290            | 162,290              | 21,780          | 21,694           |
| R-squared             | 0.835                | 0.209                 | 0.419              | 0.601                | 0.386           | 0.842            |

Note: Table A5 displays the characteristics of new firms joined by advisers who switched firms as a function of whether or not the adviser was reprimanded for misconduct in the year prior to the job transition (eq. 8). No. Social Network Links measures the number of individuals who follow a firm on a popular social media website as of May 2015. Firm Employee Misconduct (Misc. Rate) measures the share of financial advisers working at a firm that were reprimanded for misconduct in a given year. Observations are adviser by job transition for which the adviser found a job within a year. We restrict the data to observations in which we observe advisers who were and were not reprimanded for misconduct leave a given firm in a given year and county. Standard errors are in parenthesis and are clustered by firm. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.10$ .

Table A6: Firm Hiring

|                 | (1)      | (2)       | (3)        |
|-----------------|----------|-----------|------------|
| Firm Discipline | -0.0030* | -0.0049** | -0.0063*** |
|                 | (0.0018) | (0.0022)  | (0.0020)   |
| Firm Controls   | X        | X         | X          |
| Year F.E.       |          | X         | X          |
| State F.E.      |          |           | X          |
| Observations    | 4,063    | 4,063     | 4,063      |
| R-squared       | 0.070    | 0.093     | 0.119      |

Table A6 displays the estimation results corresponding to a firm's hiring patterns. Observations are at the firm by year level where we restrict the data set those observations where the firm hired new advisers. The dependent variable is the percentage of new hires made by a firm who were reprimanded for misconduct in the previous year. The key independent variable is Firm Discipline which reflects the percentage of financial advisers working for firm  $j$  who experienced an employment separation at time  $t + 1$  among those advisers working for firm  $j$  who received misconduct disclosures at time  $t$ . Firm controls include: the number of advisers, the firm's formation type (corporation, limited liability, etc.), firm age, whether any owner/officers have a record of misconduct, whether the firm is an investment advisory firm, whether the firm is affiliated with a financial institution, and if the firm has a referral arrangement with other advisory firms. Each observation is weighted by the square root of the number of advisers in the firm. Standard errors are in parenthesis and are clustered by firm. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.10$ .

Table A7: Alternative Misconduct Definitions

| (a) Summary Statistics |            |                       |                  |  |
|------------------------|------------|-----------------------|------------------|--|
|                        | Disclosure | Disclosure/Misconduct |                  |  |
|                        |            | Current               | Current and Past |  |
| Misconduct             |            | 0.60%                 | 7.28%            |  |
| Any Disclosure         |            | 1.62%                 | 12.74%           |  |
| Severe Misconduct 1    |            | 0.24%                 | 2.91%            |  |
| Severe Misconduct 2    |            | 0.13%                 | 1.92%            |  |

| (b) Adviser Misconduct |                    |                   |                     |                     |
|------------------------|--------------------|-------------------|---------------------|---------------------|
|                        | Misconduct         | Disclosure        | Severe Misconduct-1 | Severe Misconduct-2 |
| Prior Misconduct       | 1.90***<br>(0.074) | 3.62***<br>(0.14) | 1.53***<br>(0.091)  | 1.15***<br>(0.085)  |
| Adviser Controls       | X                  | X                 | X                   | X                   |
| Year×Firm×County F.E.  | X                  | X                 | X                   | X                   |
| Observations           | 7,597,776          | 7,597,776         | 7,597,776           | 7,597,776           |
| R-squared              | 0.092              | 0.099             | 0.091               | 0.091               |

Note: Table A7a displays the incidence of disclosures/misconduct among financial advisers over the period 2005-2015 under our alternative definitions of misconduct. Observations are year by adviser. The row labeled "Misconduct" corresponds to our baseline definition of misconduct discussed in Section 3. Severe Misconduct 1 and 2 correspond to our alternate definitions of misconduct discussed in Section 6. The column "Current" displays the share of observations in which the adviser received one or more of a given type of disclosure that particular year. The column "Current and Past" displays the share of observations in which the adviser was received one or more of a given type of disclosure in that year and/or previously.

Table A7b displays the regression results for a linear probability model (eq. 1). The dependent variable is whether or not a financial adviser received a misconduct disclosure at time  $t$ . Coefficient units are percentage points. Observations are at the adviser by year level. Adviser controls include the adviser's experience, tests (series 6, 7, 63, 24 and investment adviser exam), and number of other qualifications. Columns (1)-(4) differ in terms of how misconduct and prior misconduct are defined. Standard errors are in parenthesis and are clustered by firm. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.10$ .

Table A8: Labor Market Consequences of Misconduct - Alternative Misconduct Definitions

| (a) Job Turnover                      |         |      |            |               |               |
|---------------------------------------|---------|------|------------|---------------|---------------|
|                                       | No Misc | Misc | Disclosure | Severe Misc-1 | Severe Misc-2 |
| Remain with the Firm                  | 81%     | 52%  | 69%        | 56%           | 50%           |
| Leave the Firm                        | 19%     | 48%  | 31%        | 44%           | 50%           |
| Leave the Industry                    | 48%     | 56%  | 46%        | 55%           | 59%           |
| Join a Different Firm (within 1 year) | 52%     | 44%  | 54%        | 45%           | 41%           |

| (b) Employment Separation |                    |                   |                    |                    |
|---------------------------|--------------------|-------------------|--------------------|--------------------|
|                           | Misc               | Disclosure        | Severe Misc-1      | Severe Misc-2      |
| Misconduct                | 24.40***<br>(1.82) | 9.72***<br>(0.92) | 18.94***<br>(1.29) | 23.78***<br>(1.90) |
| Adviser Controls          | X                  | X                 | X                  | X                  |
| Year×Firm×County F.E.     | X                  | X                 | X                  | X                  |
| Observations              | 6,954,542          | 6,954,542         | 6,954,542          | 6,954,542          |
| R-squared                 | 0.326              | 0.324             | 0.324              | 0.324              |

| (c) Reemployment      |                    |                 |                    |                     |
|-----------------------|--------------------|-----------------|--------------------|---------------------|
|                       | Misc               | Disclosure      | Severe Misc-1      | Severe Misc-2       |
| Misconduct            | -9.69***<br>(1.10) | -1.16<br>(0.81) | -9.88***<br>(1.01) | -12.62***<br>(0.97) |
| Adviser Controls      | X                  | X               | X                  | X                   |
| Year×Firm×County F.E. | X                  | X               | X                  | X                   |
| Observations          | 1,246,907          | 1,246,907       | 1,246,907          | 1,246,907           |
| R-squared             | 0.373              | 0.373           | 0.373              | 0.373               |

Note: Table A8a displays the average annual job turnover among financial advisers over the period 2005-2015. Leave the industry is defined as an adviser not being employed as a financial adviser for at least one year; join a new firm is a dummy variable that takes the value of one if the adviser is employed at a different financial advisory firm within a year. The job transitions are broken down by whether or not the adviser received a disclosure, misconduct related disclosure, or severe misconduct disclosure in the previous year. Tables A8b and A8c measure the labor market consequences of misconduct by estimating linear probability models in eq. (3) and (5). In Table A8c we restrict the sample to advisers who left their firm in a given year. The coefficients are in units of percentage points. Other adviser controls include the adviser's industry experience, tests (series 6, 7, 63, 24 and investment adviser exam), and number of other qualifications. Observations are at the financial adviser by year level. The columns of each table differ with respect to how misconduct is defined. Standard errors are in parenthesis and are clustered by firm. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.10$ .

Table A9: Types of Disclosures

| Dep Var.                                | Misconduct         | Empl. Separation   | Duration Out of the Industry |
|---|--------------------|--------------------|------------------------------|
| <b>Misconduct Related Disclosures:</b>  |                    |                    |                              |
| Employment Separation After Allegations | 2.12***<br>(0.12)  | 68.94***<br>(1.56) | 0.75***<br>(0.0090)          |
| Regulatory - Final                      | 1.42***<br>(0.09)  | 9.75***<br>(0.97)  | 0.42***<br>(0.0093)          |
| Criminal - Final Disposition            | 0.57***<br>(0.039) | 6.93***<br>(0.99)  | 1.09***<br>(0.035)           |
| Customer Dispute - Settled              | 2.07***<br>(0.12)  | 2.51***<br>(0.43)  | 1.16***<br>(0.013)           |
| Customer Dispute - Award/Judgment       | 1.44***<br>(0.15)  | -1.28<br>(1.07)    | 0.90**<br>(0.044)            |
| Civil - Final                           | 1.86***<br>(0.56)  | 9.53***<br>(3.43)  | 0.34***<br>(0.042)           |
| <b>Other Disclosures:</b>               |                    |                    |                              |
| Financial - Final                       | 0.23***<br>(0.032) | 0.31<br>(0.65)     | 1.54***<br>(0.016)           |
| Judgment/Lien                           | 1.19***<br>(0.11)  | 0.19<br>(1.05)     | 1.26***<br>(0.019)           |
| Customer Dispute - Denied               | 1.34***<br>(0.095) | 1.07***<br>(0.35)  | 1.32***<br>(0.016)           |
| Customer Dispute - Closed-No Action     | 1.61***<br>(0.210) | 1.36*<br>(0.70)    | 1.25***<br>(0.028)           |
| Customer Dispute - Withdrawn            | 2.40***<br>(0.30)  | -0.62<br>(1.00)    | 1.32***<br>(0.067)           |
| Customer Dispute - Dismissed            | 0.39<br>(0.60)     | 0.47<br>(3.11)     | 0.96<br>(0.18)               |
| Customer Dispute - Final                | 2.33***<br>(0.77)  | -0.51<br>(2.48)    | 0.62***<br>(0.11)            |
| Civil Bond                              | 0.37<br>(0.36)     | -0.041<br>(4.56)   | 1.01<br>(0.21)               |
| Adviser Controls                        | X                  | X                  | X                            |
| Year×Firm×County F.E.                   | X                  | X                  |                              |
| Year F.E.                               |                    |                    | X                            |
| Observations                            | 7,597,776          | 6,954,542          | 1,357,046                    |
| R-squared                               | 0.096              | 0.329              |                              |

Note: Table A9 displays the estimation results corresponding to our three baseline models broken down by the type of disclosure. Column (1) displays the regression results for a linear probability model (eq. 1). The dependent variable is a dummy variable indicating whether or not the adviser was formally reprimanded for misconduct in year  $t$ . Coefficients are in terms of percentage points. Column (2) displays the corresponding estimates for a linear probability model where the dependent variable is a dummy variable indicating whether or not a financial adviser left his firm (eq. 3). Coefficients are in terms of percentage points. Column (3) corresponds to a Cox proportional hazard model (eq. 7). The dependent variable is the length of an unemployment spell in months. The coefficients in column (3) are reported in terms of proportional hazards. Observations are adviser by unemployment spell. In column (1) the disclosure variable indicates whether or not the adviser has previously received a disclosure of that particular type. In columns (2) and (3) the disclosure variable indicates whether or not the adviser received a disclosure of that particular type in the previous year. Other adviser controls include the adviser's experience, tests (series 6, 7, 63, 24 and investment adviser exam), and number of other qualifications. Standard errors are clustered by firm in columns (1) and (2). Robust standard errors are presented in column (3). \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.10$ .

Table A10: Consumer Sophistication and Non-Customer Initiated Misconduct

|                            | Firm Employee Misconduct      |                           |
|----------------------------|-------------------------------|---------------------------|
|                            | Non-Customer Initiated Claims | Customer Initiated Claims |
|                            | (1)                           | (2)                       |
| Retail Investors           | 1.42**<br>(0.61)              | 3.27***<br>(1.16)         |
| Number of Accts (millions) | -0.10<br>(0.56)               | 5.55***<br>(1.10)         |
| Compensation Structure:    |                               |                           |
| Assets Under Management    | 0.45<br>(0.62)                | -0.024<br>(0.89)          |
| Hourly                     | 1.39***<br>(0.40)             | 0.91<br>(0.76)            |
| Fixed Fee                  | -0.74<br>(0.49)               | -0.53<br>(0.78)           |
| Commission                 | 0.61*<br>(0.31)               | 2.67***<br>(0.60)         |
| Performance                | 0.35<br>(0.64)                | 0.66<br>(1.05)            |
| Firm Controls              | X                             | X                         |
| Year F.E.                  | X                             | X                         |
| State F.E.                 | X                             | X                         |
| Observations               | 1,125                         | 1,125                     |
| R-squared                  | 0.328                         | 0.540                     |

Note: Table A10 examines whether firms who service less sophisticated (retail) customers have higher shares of advisers with misconduct records. It displays regression results corresponding to eq. (11). Observations are at the firm by year level over the period 2011-2014 for an unbalanced panel of 435 investment advisory firms. In column (1) we measure the firm employee misconduct rate as the percentage of advisers working for a firm that have a non-customer initiated misconduct disclosure on his/her record as of time  $t$ . In column (2) we measure the firm employee misconduct rate as the percentage of advisers working for a firm that have a customer initiated misconduct disclosure on his/her record as of time  $t$ . Coefficients are in units of percentage points. Firm controls include the firm size (no. advisers), number of states the firm operates in and the age of the firm. Each observation is weighted by the square root of the number of advisers in the firm. Standard errors are in parenthesis and are clustered by firm. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.10$ .

Table A11: Non-Customer Initiated Misconduct and County Characteristics

|                   | County Misconduct                    |                                  |
|-------------------|--------------------------------------|----------------------------------|
|                   | Non-Customer Initiated Claims<br>(1) | Customer Initiated Claims<br>(2) |
| ln(pop)           | 0.029<br>(0.068)                     | 0.283**<br>(0.122)               |
| ln(inc)           | 3.39***<br>(0.86)                    | 6.51***<br>(1.43)                |
| Pct Rural         | -2.54***<br>(0.88)                   | -2.25<br>(1.48)                  |
| Pct College       | -7.98***<br>(1.69)                   | -13.46***<br>(2.70)              |
| Pct 65 or Older   | 9.88***<br>(3.19)                    | 34.09***<br>(6.03)               |
| Labor Force Part. | -0.24<br>(2.74)                      | -6.60<br>(5.12)                  |
| Year F.E.         | X                                    | X                                |
| State F.E.        | X                                    | X                                |
| Observations      | 2,607                                | 2,607                            |
| R-squared         | 0.550                                | 0.617                            |

Note: Table A11 examines which county characteristics predict misconduct, corresponding to (eq. 12). Observations are at the county by year level over the period 2010-2013. We restrict the data set to those counties with more than 50 advisers for which demographic data is available from the American Community Survey. In column (1) we measure the county misconduct rate as the percentage of advisers in a county that have a non-customer initiated misconduct disclosure on his/her record as of time  $t$ . In column (2) we measure the county misconduct rate as the percentage of advisers in a county that have a customer initiated misconduct disclosure on his/her record as of time  $t$ . Coefficients are in units of percentage points. The independent variables Pct Rural, Pct College, and Pct 65 or Older are measured on the scale 0-1. Each observation is weighted by the square root of the number of advisers in the county. Standard errors are in parenthesis and are clustered by county. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.10$ .

Table A12: Firm Dissolutions

| (a) New Firm Characteristics |                   |                |
|------------------------------|-------------------|----------------|
|                              | Misc. Rate        | Firm Size      |
| Misconduct                   | 0.35***<br>(0.12) | -827*<br>(453) |
| Original Firm x Year F.E.    | X                 | X              |
| Observations                 | 70,756            | 70,756         |
| R-squared                    | 0.532             | 0.751          |

| (b) Reemployment      |                    |                    |                    |
|-----------------------|--------------------|--------------------|--------------------|
|                       | (1)                | (2)                | (3)                |
| Misconduct            | -20.6***<br>(3.54) | -23.0***<br>(3.20) | -15.9***<br>(2.87) |
| Adviser Controls      |                    | X                  | X                  |
| Year×Firm×County F.E. |                    |                    | X                  |
| Observations          | 124,696            | 124,696            | 118,313            |
| R-squared             | 0.003              | 0.055              | 0.361              |

Note: Table A12a displays the characteristics of new firms joined by advisers who switched firms as a function of whether or not the adviser was reprimanded for misconduct in the year prior to the job transition (eq. 8). Firm Employee Misconduct (Misc. Rate) measures the share of financial advisers working at a firm that were reprimanded for misconduct in a given year. Observations are adviser by job transition for which the adviser found a job within a year. We restrict the data to observations in which we observe advisers who were and were not reprimanded for misconduct leave a given firm in a given year. We also restrict the data set to only those job transitions that were the result of a firm dissolution. Standard errors are in parenthesis and are clustered by firm. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.10$ .

Table A12b measures the labor market consequences of misconduct by estimating a linear probability model in (eq. 5). The dependent variable is a dummy variable indicating whether or not a financial adviser joined a new firm within one year. The coefficients are in units of percentage points. Other adviser controls include the adviser's industry experience, tests (series 6, 7, 63, 24 and investment adviser exam), and number of other qualifications. Observations are at the financial adviser by year level. We restrict the sample to advisers who left their firm in a given year as the result of a firm dissolution. Standard errors are in parenthesis and are clustered by firm. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.10$ .

Table A13: Investment Adviser Subsample Analysis

| (a) Incidence of Misconduct |                    |  |                             |  |  |  |  |
|-----------------------------|--------------------|--|-----------------------------|--|--|--|--|
|                             | Current Misconduct |  | Current and Past Misconduct |  |  |  |  |
| Investment Advisers         | 0.85%              |  | 10.01%                      |  |  |  |  |
| Non-Investment Advisers     | 0.43%              |  | 5.39%                       |  |  |  |  |

| (b) Consequences of Misconduct: Investment Advisers |                    |                   |                    |                              |
|---|--------------------|-------------------|--------------------|------------------------------|
|   | Misconduct         | Empl. Sep.        | Reemployment       | Duration Out of the Industry |
| Misconduct  | 1.91***<br>(0.091) | 20.3***<br>(1.28) | -9.95***<br>(1.16) | 0.82***<br>(0.0080)          |
| Other Adviser Controls                              | X                  | X                 | X                  | X                            |
| Year×Firm×County F.E.                               | X                  | X                 | X                  |                              |
| Year F.E.   |                    |                   |                    | X                            |
| Observations  | 3,022,722          | 2,754,755         | 458,469            | 535,917                      |
| R-squared   | 0.111              | 0.379             | 0.302              |                              |

| (c) Consequences of Misconduct: Non-Investment Advisers |                    |                   |                    |                              |
|---|--------------------|-------------------|--------------------|------------------------------|
|   | Misconduct         | Empl. Sep.        | Reemployment       | Duration Out of the Industry |
| Misconduct  | 1.80***<br>(0.088) | 30.2***<br>(3.09) | -9.19***<br>(1.54) | 0.86**<br>(0.011)            |
| Other Adviser Controls                                  | X                  | X                 | X                  | X                            |
| Year×Firm×County F.E.                                   | X                  | X                 | X                  |                              |
| Year F.E.   |                    |                   |                    | X                            |
| Observations  | 4,413,362          | 4,051,117         | 739,190            | 821,129                      |
| R-squared   | 0.117              | 0.319             | 0.385              |                              |

| (d) New Firm Characteristics: Investment Advisers |                       |                      |                    |                      |                    |                   |
|---|-----------------------|----------------------|--------------------|----------------------|--------------------|-------------------|
|   | Avg. Payout           | No. Social Links     | Misc. Rate (pp)    | Firm Size            | Assets (\$bn)      | Rev. (\$mm)       |
| Misconduct  | -14,327***<br>(4,289) | -9,175***<br>(1,877) | 0.38***<br>(0.048) | -2,363***<br>(288.2) | -42.4***<br>(5.47) | -430***<br>(43.5) |
| Orig Firm x Year F.E.                             | X                     | X                    | X                  | X                    | X                  | X                 |
| Observations                                      | 37,123                | 11,704               | 250,537            | 250,537              | 39,827             | 39,639            |
| R-squared   | 0.503                 | 0.060                | 0.245              | 0.346                | 0.281              | 0.438             |

| (e) New Firm Characteristics: Non-Investment Advisers |                       |                      |                   |                      |                    |                   |
|---|-----------------------|----------------------|-------------------|----------------------|--------------------|-------------------|
|   | Avg. Payout           | No. Social Links     | Misc. Rate (pp)   | Firm Size            | Assets (\$bn)      | Rev. (\$mm)       |
| Misconduct  | -25,567***<br>(5,185) | -8,490***<br>(2,451) | 0.77***<br>(0.11) | -1,407***<br>(220.3) | -31.2***<br>(7.68) | -370***<br>(72.9) |
| Orig Firm x Year F.E.                                 | X                     | X                    | X                 | X                    | X                  | X                 |
| Observations  | 18,751                | 9,306                | 143,991           | 143,991              | 22,123             | 22,024            |
| R-squared   | 0.766                 | 0.226                | 0.391             | 0.673                | 0.530              | 0.731             |

Note: In Table A13 we recompute our baseline analysis where we restrict our data set to only those advisers who are and are not registered as investment advisers. We only observe whether a financial adviser is registered as an investment adviser if the financial adviser is currently active in the industry. Hence, we treat all advisers who have completed an investment adviser examination (Series 65 or 66 exam) as being investment advisers. The results reported in Tables A13b and A13d are estimated using the set of investment advisers in the data. Tables A13c and A13e display the corresponding estimates for the pool of non-investment advisers.

Table A13a displays the incidence of misconduct among investment advisers and non-investment advisers. The column "Current" displays the share of observations in which the adviser received one or more misconduct disclosure in that particular year. The column "Current and Past" displays the share of observations in which the adviser either received or previously received one or more misconduct disclosure.

Tables A13b and A13c display the estimated results for the baseline analysis in the model where we restrict the sample to those advisers who are and are not registered as investment advisers. Columns (1)-(3) correspond to linear probability models that were estimated using adviser by year data. In column (1), the dependent variable is a dummy variable indicating whether or not the investment adviser was formally disciplined for misconduct in year  $t$  (eq. 1). In column (2), the dependent variable is a dummy variable indicating whether or not the investment adviser experienced an employment separation (eq. 3). In column (3), the dependent variable is a dummy variable indicating whether or not the investment adviser switched firms in a given year (eq. 5). In columns (1)-(3) the coefficients are in terms of percentage points. Column (4) displays the estimates corresponding to a Cox-proportional hazards model (eq. 7). The dependent variable is the length of an unemployment spell in months. The coefficients in column (4) are reported in terms of proportional hazards. Observations are adviser by unemployment spell. The key independent variables of interest are the misconduct dummy variables. In column (1) the misconduct variable indicates whether or not the adviser has ever received a misconduct disclosure. In columns (2)-(4) the misconduct variable indicates whether or not the adviser received a misconduct disclosure in the previous year. Other adviser controls include the adviser's experience, tests (series 6, 7, 63, and 24), and number of other qualifications.

Tables A13d and A13e display the characteristics of new firms joined by advisers who switched firms as a function of whether or not the adviser was reprimanded for misconduct in the year prior to the job transition (eq. 8). No. Social Network Links measures the number of individuals who follow a firm on a popular social media website as of May 2015. Firm Employee Misconduct (Misc. Rate) measures the share of financial advisers working at a firm that were reprimanded for misconduct in a given year. Observations are adviser by job transition for which the adviser found a job within a year. We restrict the data to observations in which we observe advisers who were and were not reprimanded for misconduct leave a given firm in a given year. Standard errors are clustered by firm. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.10$ .

Table A14: Disclosures - FINRA Registered, SEC Registered, and Dually Registered Advisers

(a) Disclosure Summary Statistics - Full Data Set

| Disclosure Type        | FINRA Data     |                 | SEC Data        |                    |
|------------------------|----------------|-----------------|-----------------|--------------------|
|                        | Registered Rep | Dual Registered | Dual Registered | Investment Adviser |
| Customer Dispute       | 3.14%          | 15.02%          | 14.86%          | 5.28%              |
| Bankruptcy             | 4.28%          | 4.11%           | 4.26%           | 2.46%              |
| Criminal               | 1.99%          | 2.06%           | 2.08%           | 1.44%              |
| Regulatory             | 1.04%          | 1.41%           | 1.40%           | 2.79%              |
| Termination            | 0.70%          | 1.38%           | 1.43%           | 1.75%              |
| Judgment               | 1.53%          | 1.29%           | 1.55%           | 0.94%              |
| Civil                  | 0.04%          | 0.04%           | 0.04%           | 0.19%              |
| Bond                   | 0.02%          | 0.03%           | 0.03%           | 0.04%              |
| Investigation          | 0.03%          | 0.03%           | 0.03%           | 0.13%              |
| Any Disclosure         | 10.78%         | 21.86%          | 22.00%          | 11.52%             |
| No. Financial Advisers | 372,836        | 271,446         | 277,198         | 51,256             |

(b) Disclosure Summary Statistics - Excluding Known Non-Client Facing Advisers

| Disclosure Type        | FINRA Data     |                 | SEC Data        |                    |
|------------------------|----------------|-----------------|-----------------|--------------------|
|                        | Registered Rep | Dual Registered | Dual Registered | Investment Adviser |
| Customer Dispute       | 4.02%          | 17.23%          | 17.16%          | 5.53%              |
| Bankruptcy             | 5.22%          | 4.09%           | 4.27%           | 2.55%              |
| Criminal               | 2.19%          | 2.14%           | 2.15%           | 1.48%              |
| Regulatory             | 1.10%          | 1.53%           | 1.52%           | 2.86%              |
| Termination            | 0.79%          | 1.53%           | 1.58%           | 1.84%              |
| Judgment               | 1.93%          | 1.38%           | 1.65%           | 0.98%              |
| Civil                  | 0.03%          | 0.04%           | 0.05%           | 0.17%              |
| Bond                   | 0.02%          | 0.03%           | 0.03%           | 0.04%              |
| Investigation          | 0.03%          | 0.03%           | 0.03%           | 0.13%              |
| Any Disclosure         | 12.86%         | 24.08%          | 24.32%          | 11.93%             |
| No. Financial Advisers | 246,366        | 228,860         | 231,491         | 47,541             |

Note: Table A14 displays the percentage of financial advisers with a disclosure on his/her record. We separately analyze those financial advisers that are solely registered with FINRA as Registered Representatives, those solely registered with the SEC as Investment Advisers, and those dually registered. We observe the disclosure history for each FINRA Registered Representative in FINRA's BrokerCheck database. We observe the disclosure history for each Investment Adviser in the SEC's Investment Advisor Public Disclosure (IAPD) database. We observe the disclosure history for those dually registered representatives in both the BrokerCheck and IAPD databases. The SEC Investment Advisor Public Disclosure database classifies disclosures into nine categories: customer disputes, bankruptcy, criminal, regulatory, termination, judgment, civil, bond, and investigation. We construct the corresponding categories from the 23 disclosure categories specified in FINRA's BrokerCheck database. The disclosure categories include all types of reported disclosures including those that are withdrawn, pending, or under appeal. The FINRA reported summary statistics reported in Columns (1) and (2) of Tables A14a and A14b represent all active registered representatives as of May 2015. The SEC reported summary statistics reported in Columns (3) and (4) represent all active investment advisers as of July 2016.

Table A14a reports the summary statistics using the full data set of Registered Representatives and Investment Advisers as of May 2015 and July 2016 respectively. In Table A14b we exclude those financial advisers that are known non-client facing advisers. We supplement our FINRA and SEC financial adviser data with additional data from Meridian IQ. Meridian IQ contains additional details on which advisers are not client facing for a large subset of the financial advisers in our data set. We are able to match 85% of the currently active financial advisers in BrokerCheck to the Meridian IQ data. Similarly, we are able to match the 99% of the financial advisers in the SEC IAPD data set to the Meridian IQ data.

Table A15: Client Facing Advisers

| (a) Adviser Misconduct     |                    |                    |                    |                   |                    |                    |
|----------------------------|--------------------|--------------------|--------------------|-------------------|--------------------|--------------------|
|                            | (1)                | (2)                | (3)                | (4)               | (5)                | (6)                |
| Prior Misconduct           | 1.80***<br>(0.090) | 1.65***<br>(0.083) | 1.39***<br>(0.065) | 1.87***<br>(0.10) | 1.75***<br>(0.096) | 1.46***<br>(0.074) |
| Adviser Controls           |                    | X                  | X                  |                   | X                  | X                  |
| Year×Firm×County F.E.      |                    |                    | X                  |                   |                    | X                  |
| Client Facing Definition   |                    |                    |                    |                   |                    |                    |
| Meridian IQ                | X                  | X                  | X                  |                   |                    |                    |
| Qureshi and Sokobin (2015) |                    |                    |                    | X                 | X                  | X                  |
| Observations               | 3,391,960          | 3,391,960          | 3,151,011          | 2,856,999         | 2,856,999          | 2,640,739          |
| R-squared                  | 0.004              | 0.005              | 0.115              | 0.005             | 0.005              | 0.120              |

| (b) Employment Separation  |                   |                   |                   |                   |                   |                   |
|----------------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
|                            | (1)               | (2)               | (3)               | (4)               | (5)               | (6)               |
| Misconduct                 | 16.7***<br>(1.20) | 16.4***<br>(1.10) | 11.6***<br>(0.83) | 14.2***<br>(1.11) | 14.8***<br>(1.02) | 9.35***<br>(0.62) |
| Adviser Controls           |                   | X                 | X                 |                   | X                 | X                 |
| Year×Firm×County F.E.      |                   |                   | X                 |                   |                   | X                 |
| Client Facing Definition   |                   |                   |                   |                   |                   |                   |
| Meridian IQ                | X                 | X                 | X                 |                   |                   |                   |
| Qureshi and Sokobin (2015) |                   |                   |                   | X                 | X                 | X                 |
| Observations               | 3,012,945         | 3,012,945         | 2,792,321         | 2,553,753         | 2,553,753         | 2,356,221         |
| R-squared                  | 0.002             | 0.016             | 0.486             | 0.002             | 0.010             | 0.487             |

Note: Tables A15a and A15b displays the regression results for linear probability models (eq. 1 and eq. 3). The dependent variable in Table A15a is a dummy variable indicating whether or not a financial adviser received a misconduct disclosure at time  $t$ . The dependent variable in Table A15b is a dummy variable indicating whether or not a financial adviser received a misconduct disclosure at time  $t$ . Observations are at the adviser by year level. The coefficients are in units of percentage points. Adviser controls include the adviser's industry experience, tests (series 6, 7, 63, 24 and investment adviser exam), and number of other qualifications. Standard errors are in parenthesis and are clustered by firm. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.10$ .

We restrict our sample in Tables A15a and A15b to those advisers likely to be in a client facing position. We use two different methods to restrict our sample to client facing advisers. First, we supplement our financial adviser data set with data from Meridian IQ which includes data on known non-client facing advisers. We are able to match 85% of the currently active financial advisers in our adviser data set to the Meridian IQ data. In columns (1)-(3) of Tables A15a and A15b we exclude known non-client facing advisers from our sample. Second, we define client facing advisers as those advisers registered in more than three states. As discussed in Qureshi and Sokobin (2015), they report that "Based on its experience, FINRA staff believes that brokers with more than three state registrations generally deal with public investors." We report our results using the Qureshi and Sokobin (2015) definition of client facing advisers in columns (4)-(6) of Tables A15a and A15b. Because of data availability, our analysis using the Qureshi and Sokobin (Meridian IQ) definition of client facing advisers is restricted to the set of advisers who were active as of May 2015 (June 2016).

Table A16: Firms with the Highest/Lowest Incidence of Misconduct among Client Facing Advisers

(a) % of Client Facing Advisers who have been Disciplined for Misconduct

| Rank | Firm                              | Firm CRD# | Misconduct | # Advisers |
|------|-----------------------------------|-----------|------------|------------|
| 1    | OPPENHEIMER & CO. INC.            | 249       | 28.2%      | 1,453      |
| 2    | FIRST ALLIED SECURITIES, INC.     | 32444     | 24.2%      | 677        |
| 3    | RAYMOND JAMES & ASSOCIATES, INC.  | 705       | 22.2%      | 2,973      |
| 4    | CETERA ADVISORS LLC               | 10299     | 19.5%      | 857        |
| 5    | SECURITIES AMERICA, INC.          | 10205     | 19.0%      | 1,484      |
| 6    | NATIONAL PLANNING CORPORATION     | 29604     | 18.9%      | 1,019      |
| 7    | WELLS FARGO ADVISORS FIN. NETWORK | 11025     | 18.6%      | 1,384      |
| 8    | UBS FINANCIAL SERVICES INC.       | 8174      | 18.4%      | 9,522      |
| 9    | STIFEL, NICOLAUS & COMPANY, INC.  | 793       | 18.3%      | 2,720      |
| 10   | JANNEY MONTGOMERY SCOTT LLC       | 463       | 17.7%      | 999        |

(b) % of Client Facing Advisers who have been Disciplined for Misconduct

| Rank | Firm                                    | Firm CRD# | Misconduct | # Advisers |
|------|---|-----------|------------|------------|
| 1    | MORGAN STANLEY & CO. LLC                | 8209      | 1.1%       | 1,505      |
| 2    | GOLDMAN, SACHS & CO.                    | 361       | 1.3%       | 3,087      |
| 3    | BNP PARIBAS SECURITIES CORP.            | 15794     | 1.3%       | 474        |
| 4    | BLACKROCK INVESTMENTS, LLC              | 38642     | 1.5%       | 1,035      |
| 5    | UBS SECURITIES LLC                      | 7654      | 1.7%       | 761        |
| 6    | PRUDENTIAL INVESTMENT MGMT SERVICES LLC | 18353     | 1.8%       | 739        |
| 7    | SUNTRUST ROBINSON HUMPHREY, INC.        | 6271      | 1.8%       | 218        |
| 8    | WELLS FARGO SECURITIES, LLC             | 126292    | 1.9%       | 1,973      |
| 9    | GWFS EQUITIES, INC.                     | 13109     | 2.0%       | 1,051      |
| 10   | NATIONAL FINANCIAL SERVICES LLC         | 13041     | 2.2%       | 178        |

Note: Tables A16a and A16b display the firms in the U.S. with the highest and lowest employee misconduct rates as of May 2015. Firms are defined by their Central Registration Depository (CRD) number. Misconduct is defined as the percentage of client facing advisers working for a firm that have been reprimanded for misconduct in the past. We define client facing advisers in Tables A16a and A16b as those advisers registered in more than three states. As discussed in Qureshi and Sokobin (2015), they report that "Based on its experience, FINRA staff believes that brokers with more than three state registrations generally deal with public investors." We restrict the set of firms to those with at least 1,000 registered representatives and at least 100 client facing advisers.

Table A16: Firms with the Highest/Lowest Incidence of Misconduct among Client Facing Advisers

(c) % of Client Facing Advisers (Alt. Defn.) who have been Disciplined for Misconduct

| Rank | Firm  | Firm CRD# | Misconduct | # Advisers |
|------|---|-----------|------------|------------|
| 1    | OPPENHEIMER & CO. INC.                      | 249       | 24.3%      | 1,720      |
| 2    | FIRST ALLIED SECURITIES, INC.               | 32444     | 20.3%      | 905        |
| 3    | RAYMOND JAMES & ASSOCIATES, INC.            | 705       | 19.1%      | 3,613      |
| 4    | UBS FINANCIAL SERVICES INC.                 | 8174      | 19.0%      | 9,370      |
| 5    | STIFEL, NICOLAUS & COMPANY, INCORPORATED    | 793       | 18.4%      | 2,693      |
| 6    | WELLS FARGO ADVISORS FINANCIAL NETWORK, LLC | 11025     | 17.2%      | 1,527      |
| 7    | JANNEY MONTGOMERY SCOTT LLC                 | 463       | 16.9%      | 998        |
| 8    | SECURITIES AMERICA, INC.                    | 10205     | 16.1%      | 2,137      |
| 9    | CETERA ADVISORS LLC                         | 10299     | 15.9%      | 1,252      |
| 10   | MORGAN STANLEY                              | 149777    | 15.8%      | 18,778     |

(d) % of Client Facing Advisers (Alt. Defn.) who have been Disciplined for Misconduct

| Rank | Firm                                   | Firm CRD# | Misconduct | # Advisers |
|------|--|-----------|------------|------------|
| 1    | MORGAN STANLEY & CO. LLC               | 8209      | 0.6%       | 1,696      |
| 2    | JACKSON NATIONAL LIFE DISTRIBUTORS LLC | 40178     | 0.7%       | 408        |
| 3    | GOLDMAN, SACHS & CO.                   | 361       | 0.9%       | 5,157      |
| 4    | PRUDENTIAL INV. MGMT SERVICES LLC      | 18353     | 1.1%       | 280        |
| 5    | UBS SECURITIES LLC                     | 7654      | 1.2%       | 607        |
| 6    | SUNTRUST ROBINSON HUMPHREY, INC.       | 6271      | 1.2%       | 167        |
| 7    | BLACKROCK INVESTMENTS, LLC             | 38642     | 1.2%       | 245        |
| 8    | WELLS FARGO SECURITIES, LLC            | 126292    | 1.3%       | 624        |
| 9    | JEFFERIES LLC                          | 2347      | 1.8%       | 799        |
| 10   | NATIONWIDE INV. SERVICES CORP.         | 7110      | 1.8%       | 1,305      |

Note: Tables A16c and A16d display the firms in the U.S. with the highest and lowest employee misconduct rates as of May 2015. Firms are defined by their Central Registration Depository (CRD) number. Misconduct is defined as the percentage of client facing advisers working for a firm that have been reprimanded for misconduct in the past. We use data from Meridian IQ to help determine which advisers are client facing. When constructing Tables A16c and A16d we exclude those advisers in the Meridian IQ database that are known non-client facing advisers as of 2016. We also restrict the set of firms to those with at least 1,000 registered representatives and at least 100 client facing advisers.

Table A17: Controlling for Adviser Quality, Size, and Profitability

| (a) Adviser Misconduct |                     |                     |                    |
|------------------------|---------------------|---------------------|--------------------|
|                        | (1)                 | (2)                 | (3)                |
| Prior Misconduct       | 1.63***<br>(0.11)   | 1.65***<br>(0.11)   | 1.42***<br>(0.097) |
| High Quality Rating    | 0.056<br>(0.071)    | -0.0037<br>(0.066)  | 0.011<br>(0.059)   |
| ln(AUM)                | 0.056***<br>(0.016) | 0.049***<br>(0.013) | 0.029*<br>(0.016)  |
| ln(Revenue)            | 0.20***<br>(0.022)  | 0.20***<br>(0.022)  | 0.17***<br>(0.021) |
| Adviser Controls       |                     | X                   | X                  |
| Year×Firm×County F.E.  |                     |                     | X                  |
| Observations           | 696,842             | 696,842             | 575,312            |
| R-squared              | 0.004               | 0.005               | 0.176              |

| (b) Employment Separation |                   |                    |                     |
|---------------------------|-------------------|--------------------|---------------------|
|                           | (1)               | (2)                | (3)                 |
| Misconduct                | 15.2***<br>(1.22) | 15.1***<br>(1.19)  | 9.30***<br>(0.87)   |
| High Quality Rating       | -2.70**<br>(1.32) | -3.68***<br>(1.11) | -4.02***<br>(0.64)  |
| ln(AUM)                   | 0.0078<br>(0.24)  | -0.086<br>(0.16)   | -0.41***<br>(0.066) |
| ln(Revenue)               | -0.27<br>(0.19)   | 0.012<br>(0.18)    | -0.26***<br>(0.068) |
| Other Adviser Controls    |                   | X                  | X                   |
| Year×Firm×County F.E.     |                   |                    | X                   |
| Observations              | 632,775           | 632,775            | 522,118             |
| R-squared                 | 0.005             | 0.015              | 0.623               |

Note: Tables A17a and A17b display the regression results for linear probability models. The dependent variable in Table A17a is a dummy variable indicating whether or not the adviser was formally disciplined for misconduct in year  $t$ . The key independent variable of interest is Prior Misconduct which indicates whether or not the adviser has been disciplined previously for misconduct. The dependent variable in Table A17b is a dummy variable indicating whether or not a financial adviser left his firm. The key independent variable of interest is Misconduct which indicates whether or not an adviser received a misconduct disclosure in the previous year. We also control for the adviser's self-reported AUM and the revenue (production) generated by the adviser as of 2016 which is available from Meridian IQ. Meridian IQ also generates a proprietary measure of adviser quality. The control variable High Quality Rating indicates a high rating as of 2016. Other adviser controls include the adviser's experience, tests (series 6, 7, 63, 24 and investment adviser exam), and number of other qualifications. Observations in Tables A17a and A17b are financial advisers by year over the period 2005-2015. Coefficients are in terms of percentage points. Standard errors are in parenthesis and are clustered by firm. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.10$ .

Figure A1: BrokerCheck Examples

(a) BrokerCheck Example

**John Doe**

This broker is not currently registered.

**Report Summary for this Broker**



This report summary provides an overview of the broker's professional background and conduct. Additional information can be found in the detailed report.

**Broker Qualifications**

**This broker is not currently registered.**

**This broker has passed:**

- 0 Principal/Supervisory Exams
- 1 General Industry/Product Exam
- 2 State Securities Law Exams

**Registration History**

**This broker was previously registered with the following securities firm(s):**

**INTERNATIONAL ASSETS ADVISORY, LLC**  
 CRD# 10645  
 ORLANDO, FL  
 05/2013 - 06/2014

**SECURITIES AMERICA, INC.**  
 CRD# 10205  
 CHARLOTTESVILLE, VA  
 03/2013 - 04/2013

**CAMBRIDGE INVESTMENT RESEARCH, INC.**  
 CRD# 39543  
 CHARLOTTESVILLE, VA  
 06/2010 - 04/2013

**Disclosure Events**

All individuals registered to sell securities or provide investment advice are required to disclose customer complaints and arbitrations, regulatory actions, employment terminations, bankruptcy filings, and criminal or civil judicial proceedings.

Are there events disclosed about this broker? **Yes**

**The following types of disclosures have been reported:**

| Type             | Count |
|------------------|-------|
| Investigation    | 1     |
| Customer Dispute | 2     |
| Termination      | 2     |

**Investment Adviser Representative Information**

The information below represents the individual's record as a broker. For details on this individual's record as an investment adviser representative, visit the SEC's Investment Adviser Public Disclosure website at <http://www.adviserinfo.sec.gov>

(b) BrokerCheck Example

**MARK L. EGAN**

CRD# 5086791

This broker is not currently registered.

**Report Summary for this Broker**



This report summary provides an overview of the broker's professional background and conduct. Additional information can be found in the detailed report.

**Broker Qualifications**

**This broker is not currently registered.**

**This broker has passed:**

- 0 Principal/Supervisory Exams
- 1 General Industry/Product Exam
- 1 State Securities Law Exam

**Registration History**

**This broker was previously registered with the following securities firm(s):**

**BARCLAYS CAPITAL INC.**  
 CRD# 19714  
 NEW YORK, NY  
 09/2008 - 08/2010

**Disclosure Events**

All individuals registered to sell securities or provide investment advice are required to disclose customer complaints and arbitrations, regulatory actions, employment terminations, bankruptcy filings, and criminal or civil judicial proceedings.

Are there events disclosed about this broker? **No**

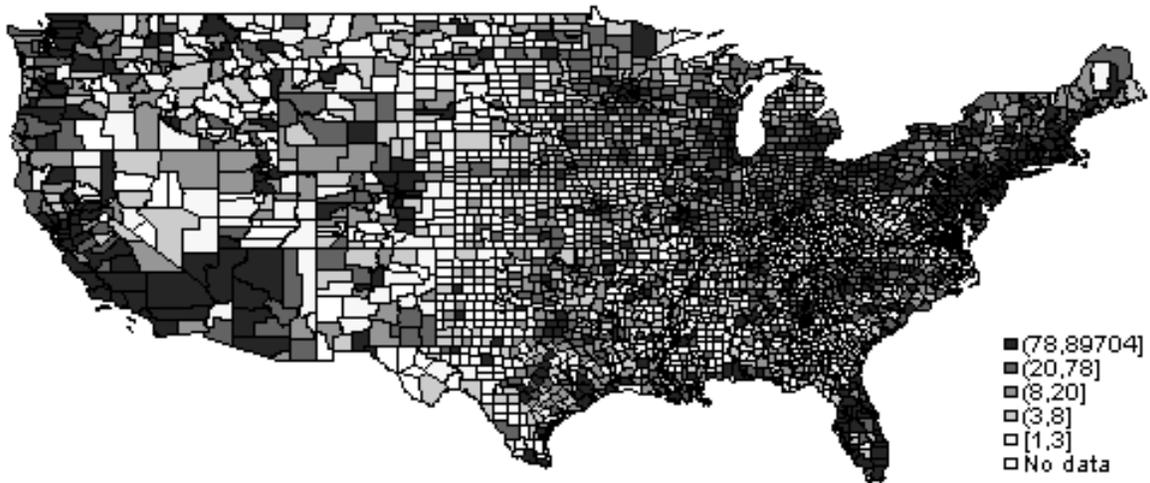
Figure A1: BrokerCheck Examples

(c) BrokerCheck Example

| <b>Customer Dispute - Settled</b>   |   |
|---|---|
| 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. |   |
| <b>Disclosure 1 of 1</b>  |   |
| <b>Reporting Source:</b>  | Firm  |
| <b>Employing firm when activities occurred which led to the complaint:</b>  | STATE FARM VP MANAGEMENT CO.  |
| <b>Allegations:</b>   | ALLEGATIONS INDIVIDUAL STOLE MONEY FROM CUSTOMER'S ACCOUNTS, OPENED ACCOUNTS IN CUSTOMER'S NAME WITHOUT HER KNOWLEDGE AND CONSENT, AND FRAUDULENTLY USED CUSTOMER'S DEBIT CARD. ACTIVITY IS ALLEGED TO HAVE OCCUREED BETWEEN JULY 8, 2008 AND APRIL 28, 2011. |
| <b>Product Type:</b>  | Annuity-Fixed<br>Banking Products (other than CDs)<br>Mutual Fund   |
| <b>Alleged Damages:</b>   | \$0.00  |
| <b>Alleged Damages Amount Explanation (if amount not exact):</b>  | NO SPECIFIC AMOUNT CLAIMED. DAMAGES ALLEGED WOULD BE IN EXCESS OF \$5,000.  |
| <b>Arbitration Information</b>  |   |
| <b>Arbitration/CFTC reparation claim filed with (FINRA, AAA, CFTC, etc.):</b>   | FINRA   |
| <b>Docket/Case #:</b>   | 12-04177  |
| <b>Date Notice/Process Served:</b>  | 12/26/2012  |
| <b>Arbitration Pending?</b>   | No  |
| <b>Disposition:</b>   | Settled   |
| <b>Disposition Date:</b>  | 01/30/2014  |
| <b>Monetary Compensation Amount:</b>  | \$40,000.00   |

Figure A1 panels (a)-(c) display three real-world examples of BrokerCheck reports. The name/identification details in panel (a) have been intentionally omitted by the authors of this paper.

Figure A2: Distribution of Financial Advisers in the US



Note: Figure A2 displays the geographic distribution of advisers in terms of advisers per county in the US as of May 2015.