Discussion of

"Regulator Jurisdiction and Investment Adviser Misconduct"

Ben Charoenwong
Alan Kwan
Tarik Umar

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Jonathan Reuter
Boston College & NBER

Putting Paper into Context

- Why should it matter whether a financial adviser is overseen by a federal regulator versus state regulator?
- Choice could effect **Pr(detect misconduct | misconduct)**
  - Could reflect differences in **resources**, information, specialization...
  - ...or likelihood of conducting audits versus responding to clients
  - Local regulator might place greater weight on local investors
- Choice could effect **Pr(detect misconduct | no misconduct)**
  - There could be more or fewer **false positives** for reasons related to differences in resources and specialization and pro-activeness
- Choice could effect **E[penalty]**
  - State regulators could impose harsher penalties with goal of protecting local investors... but also be better or worse at detecting it
- Choice could ultimately increase or decrease **Pr(misconduct)**

Existing Literature – Theory

- Predictions implicitly grounded in models of rational misconduct
  - Becker's "Crime and Punishment..." (JPE 1968); Darby & Karni's "Free competition and the optimal amount of fraud" (JLE 1973)
  - In the context of this paper: **If I am less likely to be caught, I am more likely to violate my fiduciary duty**
- Predictions could also be linked to Gennaioli et al. "Money Doctors" (JF 2015), in which advisers and clients split gains from trade
  - Under state regulator, marginal investor could be less sophisticated ➜
  - Gain to trade between adviser and client could reflect lower quality outside option ➜
  - Greater perceived misconduct... that is less likely to be detected(?)
- **Comment #1:** My prior is/was that these models would be more useful describing variation in quality of advice under suitability standard (broker-dealer) than under fiduciary standard (RIA)

Existing Literature – Empirical

- Largely focused on potential conflicts of interest arising from **broker-dealer (BD) payment model**
- **Fund-level** evidence:
  - Bergstresser et al. (RFS 2009): **broker-sold** funds earn lower alphas
  - Del Guercio and Reuter (JF 2014): ... because **broker-sold fund** do not compete on alpha for broker clients; retail market is segmented
  - Christoffersen et al. (JF 2013): **Broker** commissions impact flows
- **Account-level** evidence:
  - Several interesting papers using data from European banks (e.g., Hoechle, Ruenzi, Schaub, and Schmid (RFS 2018))
  - Mullainathan et al. (WP 2012): mystery shopper study of advice (**BD** and **RIA**) relative to specific counterfactuals
  - Foerster et al. (JF 2017): study portfolios of **broker clients** in Canada; Linnainmaa et al. (WP 2017): study **portfolios of brokers** and find they also hold expensive actively managed funds

Existing Literature – Empirical (2)

- **Account-level** evidence (cont.):
  - Chalmers and Reuter (2018) use quasi-natural experiment to identify counterfactual portfolios when brokers are/aren't available
- Many of the papers cited above appear in CEA and DOL reports arguing for fiduciary standard for IRAs (i.e., argue that BDs should behave more like RIAs)
- **Broker-level** evidence:
  - Egan et al. (JPE 2018): use BrokerCheck data to measure frequency of misconduct and likelihood of recidivism; document that some firms are more accepting of prior misconduct
    - Lack data on RIAs; do not distinguish BD from hybrid BD/RIAs
  - Dimmock et al. (JF 2018): identify peer effects with respect to broker-level misconduct by exploiting firm mergers
  - Qureshi and Sokobin (WP 2015): misconduct histories of broker's co-workers help to predict future misconduct

What Does This Paper Do?

- This paper uses **quasi-natural experiment** with respect to which RIAs are overseen by SEC versus state regulators to provide **adviser-level** evidence on misconduct by **RIAs**
- **Experiment:**
  - In July 2011, oversight of mid-sized RIAs shifted from SEC to state regulators (because of Dodd-Frank)
  - Excludes RIAs managing < $25M (always state regulator) and RIAs managing > $100M (always SEC)
  - Excludes pure BD (regulated by FINRA) and RIAs in WY and NY
- **Main Empirical Strategy:**
  - Test whether likelihood of complaint against RIAs employed by mid-sized firms **(treated)** changed more following the change in oversight than likelihood of complaint against RIAs employed by larger firms **(control)**...
  - ... by estimating standard “difference in differences” specifications

What Does This Paper Do? (2)

- **Implementing this empirical strategy requires A LOT of data:**
  - FOIA of Form ADV-W ➜ Identify partial deregistrations in 2012
  - Collect Invest Adviser Public Disclosure (IAPD) by scrapping all CRD between 1 and 10,000,000
  - Construct adviser-year panel indicating whether adviser was subject of one or more client-initiated complaint, “regardless of the status as of our data access date”
    - However, also possess data on nature of complaint and resolution
  - Supplement with “hand-collect data on securities regulators’ budgets for each state”
- **Authors find evidence that likelihood of financial misconduct increases among treated firms and, based on several additional tests, conclude that this finding reflects the greater resource constraints of local regulators**

My Assessment

- This is a very interesting paper
- Analysis is well-executed
  - Many of the tests that I was going to recommend already appear as robustness tests
  - I’m inclined to accept the conclusion that the effectiveness of state oversight depends on the level of state regulator resource
- Findings are also provocative
  - Is the scope of “bad” advice similar for BDs and RIAs?

Comment #1

- **How much should I update prior that RIA model is better for investors than BD business model?**
  - **Economic significance?**
    - **Baseline:** "probability of receiving a complaint is **1.25%** for the full sample" (which includes control RIAs of all AUM levels)
    - Increase of **0.53%** for treated firms (T1) after the change in oversight is **a large fraction of a small fraction**
    - How long does it take for additional complaints to surface?
    - Appendix Table 2: Pr(complaints) is decreasing in firm AUM ➜ helpful to report statistics for control sample with AUM < $300M
  - How do complaint rates for pure RIA compare to those for pure BD and hybrid BD/RIAs (with AUM < $300M)
  - **Bottom line for RIAs?** **Trust but verify?**

Comment #2

- **Treatment versus Control?**
  - Authors should be commended for estimating specifications using several different control samples
  - **However, I recommend excluding RIAs above $300M from most/all specifications**
    - Table 1: 17,845 treated advisers vs. 265,478 control advisers
    - Appendix Table 8: median control firm manages $285M, 75th percentile is $882M, 90th percentile is $4.1B
  - **I also recommend estimating specification that compares small RIA (which are always overseen by state) to mid-size RIA before and after switch from SEC to state**
  - Should authors distinguish RIA from hybrid RIA/BD (which are also subject to FINRA)?

Comment #3

- **Mechanism?**
  - The authors use data on state-level resources to demonstrate that complaints increase more when treated firms are in states with fewer resources
    - **I recommend limiting sample to states for which budgets are observed... rather than imputing missing values as 0**
    - **I recommend exploring variation in the level of resources relative to the number of newly covered firms**
  - Are states with greater resource constraints less likely to conduct routine audits of RIAs?
  - Evidence on the changing nature of complaints (e.g., suitability) and type of product (e.g., equity) belongs in the text

Comment #4

- **Changes in firm behavior?**
  - The appendix reveals numerous differences between treated RIAs and control RIAs
    - Appendix T6: Treated advisers are more likely to leave sample after complaint during **SEC oversight** but not **state oversight**
    - Appendix T8: Treated firms have higher % custody, lower % independent audits
  - **Does change in oversight increase likelihood of treated RIA hiring new adviser with prior misconduct complaint?**
  - **Does the likelihood of merger between mid-size RIAs go down if both are subject to state oversight?**
  - Could distinguish young, growing firms that are still below $100M from older firms that switch to state oversight due to loss of assets (possibly due to prior misconduct)?

Comment #5

- **Changes in investor composition?**
  - Table 9: complaints increase more at treated firms in counties with greater % of those age 60+...
  - ... despite my prior that elderly investors should be less able to detect misconduct (e.g., Finke and Reuter (2017))
  - Appendix T8: Treated firms have higher % unsophisticated clients
  - **Does empirical strategy predict change in % unsophisticated?**
  - **How about empirical strategy that includes measure of state-level resources?**
  - **Is it possible to calculate firm-level complaint *rates* to rule out cases where Pr(misconduct) is constant but the number of complaints is growing because number of clients is growing?**