Discussion of

"Unlocking Clients"

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WEALTH MATTERS

As Big Firms Exit Broker Pact, Investors Are Uneasy

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Research question in this paper and *Clifford and Gerken (WP 2017):*

SHOULD INVESTORS BE UNEASY?

Summary of Paper

- Study behavior of broker-dealers & registered investment advisers
- Exploit staggered firm-level entry into “**Broker Protocol**” which allowed advisers to retain client lists when moving to another Protocol firm ➜ relaxation of non-compete agreements (NCA) intended to lower firms’ legal fees
- Exploit across-state variation in enforceability of NCAs to test for differential effects within (large) Protocol firms
- **Four Main Findings**
    1. Increased mobility of advisers and AUM between Protocol firms ➜ firms join protocol to poach rival advisers and assets
    2. Protocol firms are less likely to fire advisers for misconduct
    3. Protocol advisers are 40-60% more likely to engage in misconduct
    4. Firms pass “added costs associated with their loss of control of their relationship assets on to their clients in the form of higher fees”

Big Economic Question

- **Theory of the Firm:** Who should own the property rights to an asset? (e.g., *Grossman and Hart (JPE 1986)*)
- When the firm "owns" the clients of financial advisers, it has an incentive to monitor and invest in the agent
- When the agent owns the relationships, she has an incentive to exert effort to maintain the relationship
- **Choice:** Is it better for firms to underinvest in agents or for agents to underinvest in clients?
- **NCA makes sense if clients benefit more from firm resources than from adviser actions… but clients underestimate the role that firms play**

Related Research – Different Setting

- Mutual fund families respond to rise of hedge funds by switching to anonymous management, thereby reducing the bargaining power of mutual fund managers following positive returns (*Massimo, Reuter, Zitzewitz (JFE 2010)*)
  - *Holdup arises when investors underestimate role that families plays in return generating process*
- Increased state-level enforceability of non-compete agreements results in greater mutual fund manager effort (*Cici, Hendriock, Kempf (SSRN 3151473)*)
  - *Complementary evidence that NCAs can be useful*
  - State-level changes occur in TX, FL, and LA between 1994 and 2003, which pre-date Broker Protocol

Different Shocks – Same Setting

- I am aware of two other sources of **within-firm, time-series variation** that may influence adviser behavior
- RIA misconduct increases when enforcement shifts in **2012** from SEC to state agencies, particularly in states with fewer resources (*Charoenwong, Kwan, and Umar (SSRN 2899883)*)
- Dual-registered firms charge higher fees than RIAs and are more likely to be accused of misconduct (*Boyson (SSRN 3360537)*)
  - "A **2007** surprise ruling by the Washington D.C. Court of Appeals required brokers to convert their fee-based brokerage accounts to Registered Investment Adviser (RIA) accounts."
  - **Changing business models contributing to fee increases?**

Same Shock – Same Setting

- *Clifford and Gerken (SSRN 3064204)* study adviser mobility, investments in human capital, and misconduct
- Similar findings with respect to adviser mobility (but no findings with respect to changes in AUM)
- **Contradictory findings w.r.t. adviser misconduct**
  - "[A]fter advisors enters the Protocol, they are almost three times more likely to make the Barron's Top Advisor list, they have more client assets under management, and their **incidence of client disputes drops by 20%**."
- Changes to investments in human capital:
  - "[A]fter an advisor enters the Protocol, the advisor is 17% more likely to obtain additional licensing, relative to the unconditional benchmark" and "15% less likely to obtain supervisory licenses"

Reconciling More/Less Misconduct?

- Specifications in both papers are similar in spirit
- Evidence of increased misconduct is weakest when controlling for adviser's past misconduct...
- ... strongest when dropping past misconduct and including adviser fixed effect (see also Table IA.VI)
- *If advisers respond to protocol by adding products, this could cause temporary increase in Pr(misconduct) in post-period while learning by doing*
- *Rather than include adviser FE, control for level of experience with each product type?*
- *Run separate specifications for those with and without past misconduct (prior to Protocol)?*

Protocol Exits

- As the authors point out, there have been recent high-profile exits. *Does firm-level and adviser-level behavior revert following exit?*

	Enter	Exit	Covered		Examples
2004	4		4	+	Merrill Lynch, Smith Barney, UBS
2005	1		5		
2006	11		16	+	Raymond James, Wells Fargo
2007	23		39	+	Credit Suisse
2008	85		124	+	D.A. Davidson, RBC
2009	281		405	+	Ameriprise, Morgan Stanley
2010	190	4	591	+	Waddell & Reed
2011	163	11	743	+	Barclays Wealth
2012	171	14	900	+	Baird
2013	119	10	1009		
2014	171	12	1168		
2015	153	12	1309		
2016	167	22	1454	-	Barclays Wealth
2017	218	23	1649	-	Morgan Stanley, UBS
2018	125	15	1759	-	Citi
1/2019 - 5/2019	36	3	1792		
Grand Total	1918	126			

Protocol Restrictions

- 30 (mostly large) firms enter Protocol with restrictions or subsequently add restrictions
  - Limiting types of employees covered by Protocol
  - Excluding accounts purchased by the firm
- Includes Ameriprise, Citigroup, J.P. Morgan, LPL, Merrill Lynch, Raymond James, Wells Fargo
- *Is adviser mobility reduced when firms introduce restrictions?*
- *Are reductions in firm monitoring attenuated when firms introduce restrictions?*
- *Are increases in misconduct attenuated?*

Movements of Advisers and AUM

- *InvestmentNews* “Advisers on the Move” database provides another way to estimate changes in AUM
- 153 advisers leaving UBS controlled $9.5B in 2018

Advisers on the Move, 2018

	Firm	Advisers Leaving	Advisers Joining	Net	AUM	Protocol Firm?	Restrictions?	Note
1	Wells Fargo	844	326	-518		Yes	Yes	**Scandals in 2016**
2	UBS	153	.	-153	**-9.53 Billion**	**No**		**Exited 12/2017**
3	JP Morgan	268	136	-132		Yes	Yes	
4	Northwestern Mutual	104	.	-104				
5	MML Investors Services	211	111	-100				
6	Waddell & Reed	97	.	-97		Yes		
7	Morgan Stanley	261	170	-91		**No**		**Exited 11/2017**
8	NYLIFE Securities	79	.	-79				
9	Fidelity Brokerage Services	73	.	-73				
10	AXA	124	60	-64				
...								
21	Cambridge Investment Research	71	140	69		Yes		
22	Ameriprise	207	278	71		Yes	Yes	
23	Merrill Lynch	408	486	78		Yes	Yes	
24	Commonwealth Financial Network	.	85	85				
25	Edward Jones	231	324	93				

- (Table also reveals use of restrictions)

Role of Compensation Model

- Recently, Bank of America moved 300 salaried advisers into Merrill Lynch Wealth Management...
- Salary model may reduce value of owning clients (and spur turnover of advisers under commission model)

A new pay model: 300 advisers move, and the entire industry feels the shift

As some wirehouses hire more salaried advisers, speculation mounts that the traditional way of compensating brokers is being threatened

May 4, 2019 @ 6:00 am

By **Bruce Kelly**

Other Questions for Authors

- Data on IBD revenue and AUM includes “average payout per rep” and “total payout”?
- Does average payout or total payout scaled by AUM increase following adoption of Broker Protocol?
- Does the probability that a firm punishes misconduct depend on the number of Protocol firms in the same geographic area?
- Are movers to Protocol firms more likely to engage in misconduct than advisers who do not move?