

WHO SHOULD REGULATE INVESTMENT ADVISERS?

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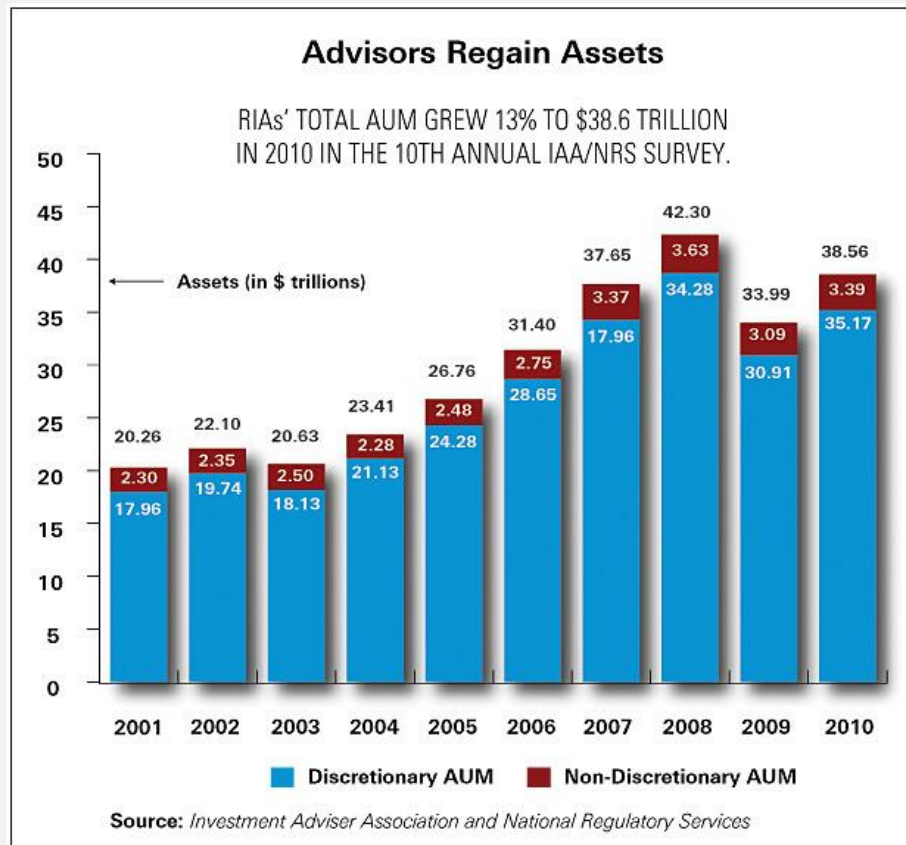
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INTRODUCTION

- What is the effect of regulatory jurisdiction on the behavior of financial actors? Specifically, investment adviser misconduct?
- Setting: Dodd-Frank re-jurisdicts “mid-size” RIAs in all but two states from SEC to state jurisdiction
- **Key contribution:** The extant literature documents dynamics of bad behavior, but there has been no focus on external governance.
- Regulatory jurisdiction is a fiery debate with few empirical laboratories. – 200 years old debate in the US (federalism)
 - Recent regulatory changes in Dodd-Frank may have created jurisdictional overlaps and confusion
- **Key contribution:** Only one other laboratories. Not all financial institutions can capture regulators. Regulator roles different.

IMPORTANCE OF INVESTMENT ADVISERS IN USA



FIDUCIARY DUTY

- In USA, investment advisers have a fiduciary duty to their clients.
- It is the highest standard of legal care that requires full disclosure of any potential conflicts of interest.
- The fiduciary duty consists of
 - the duty of care,
 - duty of loyalty,
 - duty of good faith,
 - duty of confidentiality,
 - duty of prudence,
 - and duty of disclosure.
- If a person violates their fiduciary duty, they are personally liable to account for the ill-gotten profits. However, a fiduciary duty does not imply that the person must place their client or investors' interests before their own.

INVESTMENT ADVISOR COMPANY: WHO IS THE REGULATOR?

Dodd-Frank

	2011-JUN	2012-JAN
LARGE: $\$100 < \text{AUM}$	SEC	SEC
MEDIUM: $\$25 < \text{AUM} \leq \100	SEC	STATE*
SMALL: $\text{AUM} \leq \$25$	STATE	STATE

*Except for NY & Wyoming

Treatment

“INVESTMENT ADVISORS”: 2 TYPES

Investment advisors: *“Any person who, for compensation, engages in the advisability of investing.”*

Broker/Dealer: **Broker** executes trades for clients / **dealer** executes trades for own account

90% of Investment Advisors are Broker/Dealers.

- Broker/dealers must obey “suitability” standard of conduct but not “fiduciary duty”
- **Broker/dealers are regulated by FINRA**

REGULATORY REQUIREMENTS

Provide regulator with updates of material events:

- Form ADV (to both **STATE & SEC**)
- Personal bankruptcy, civil suits, liens on personal assets
- Penalty up to \$10,000 for failure to provide updates (No data)

ROLE OF THE REGULATORS

1. Maintenance of records
 2. Scheduled or surprise audits involving site visits to firm headquarters
 3. Follow-up investigations for complaints *BUT DOES NOT ADJUDICATE*
 4. Issue sanctions / regulatory action
 5. Advertising, raising customer awareness
- One state regulator describes their role as making advisors reveal their “verification of misconduct” (costly verification)
 - Conditional on a complaint, regulators follow up. The complaint is often but not always adjudicated by *FINRA*
 - A regulator in every industry does different things, the entities we study are different than those in banking

THE DODD-FRANK ACT

- Financial crisis revealed behemoth players in financial industry were not overseen by any regulatory authority
- Dodd-Frank mandated additional SEC oversight on PE and HF firms

July 21, 2011 to December 31, 2011	January 1, 2012	March 30, 2012	June 28, 2012
New registration thresholds and requirements apply to new applicants, but not to existing SEC-registered advisers until the dates indicated in this table, as applicable.	Each SEC-registered adviser as of July 21, 2011 must remain registered with the SEC until this date (unless relying on an exemption).	Last day for all SEC-registered advisers to file the required Form ADV amendment.	Mid-sized advisers not eligible for SEC registration must file form ADV-W to withdraw by this date.

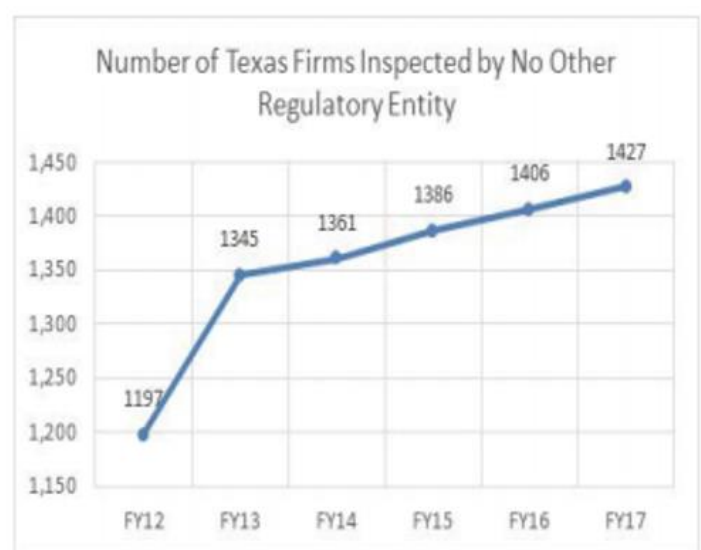
**JUNE 22, 2011
SEC OPEN MEETING:
DODD-FRANK ACT AMENDMENTS
TO THE INVESTMENT ADVISERS ACT**

Allocation of Responsibilities Between the SEC and the States

In acknowledging the Commission's limited examination resources – and in light of the new responsibilities for private fund advisers – the Dodd-Frank Act also reallocated regulatory responsibility for certain smaller investment advisers to the state securities authorities. Under the law, **advisers with between \$25 and \$100 million of assets under management are directed to register with the states, if they are subject to examination by state securities authorities.** Today's rules implement this provision.

EXAMPLE FROM TEXAS

- Texas Securities Commissioner: “It became very clear that a huge investor protection gap existed in investment adviser regulation.”



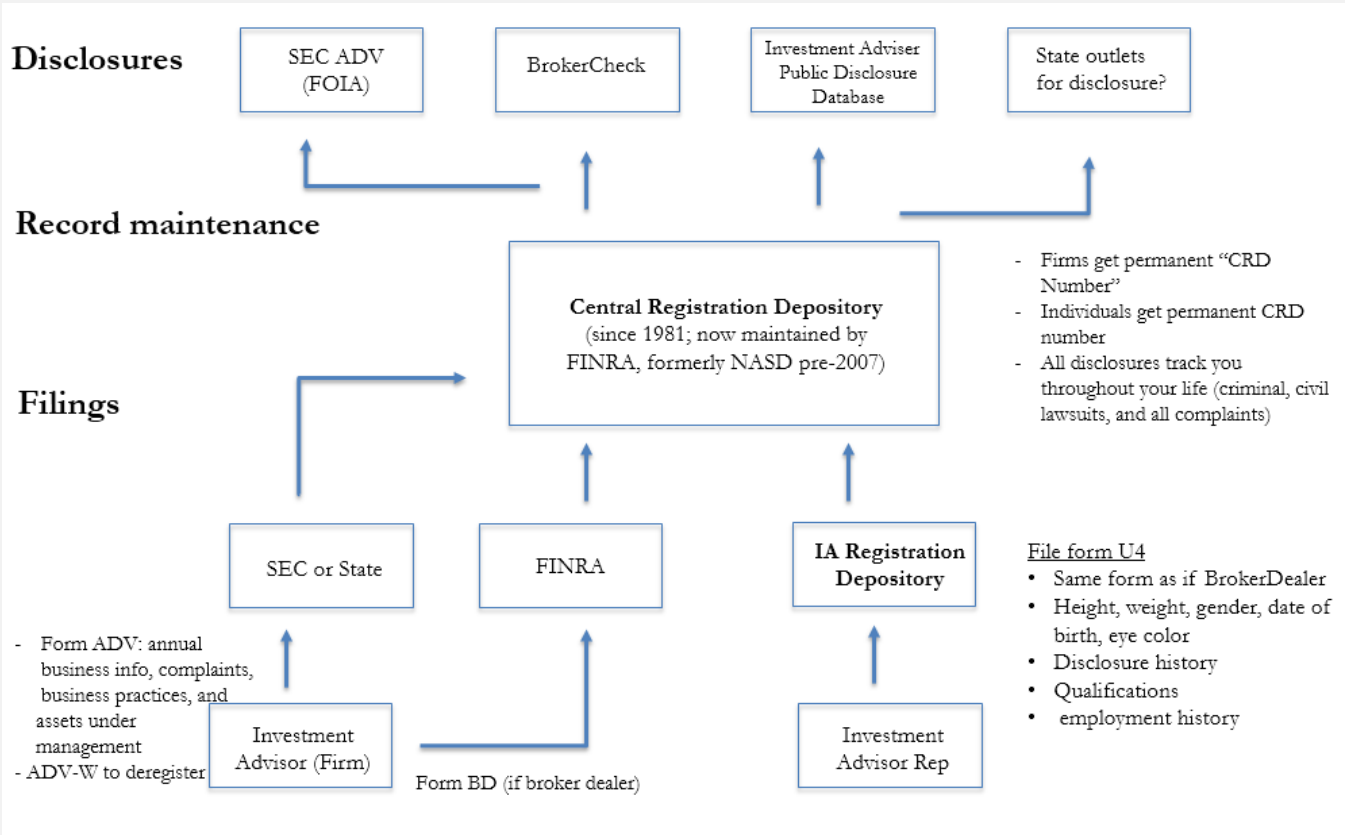
DATA

- Freedom of Information Act: Filed a request for all annual Form ADV filings for investment adviser information.

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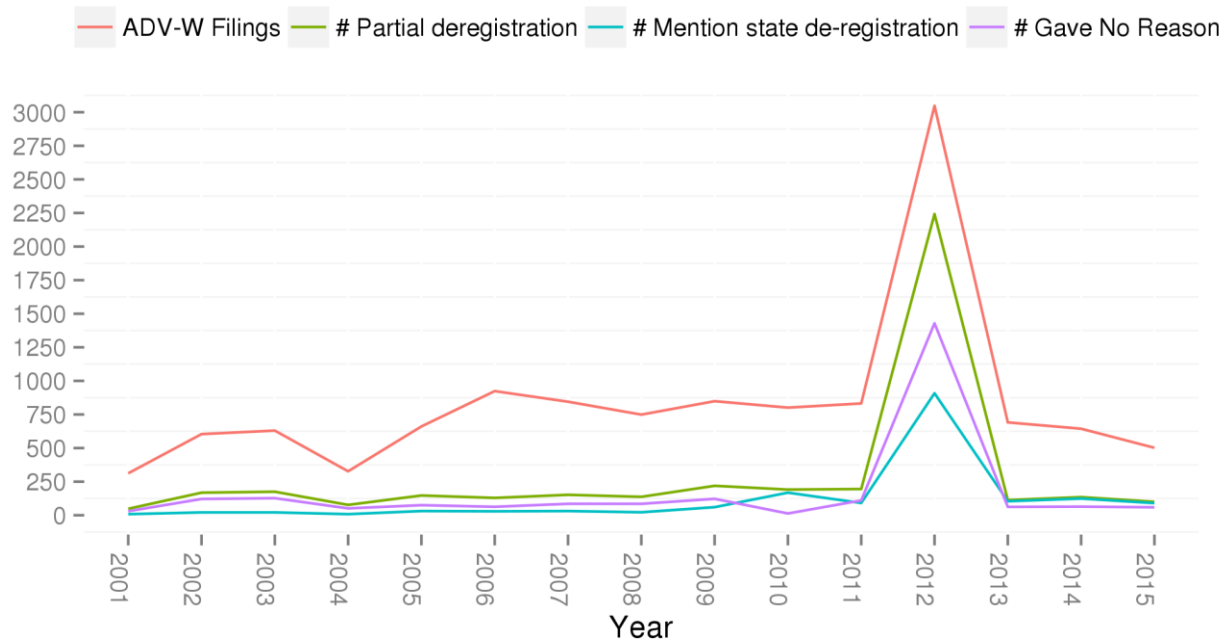
- SEC Investment Adviser Public Disclosure Database:
 - ≈500,000 PDFs describing financial adviser employment and complaint histories
- 1/3rd of advisory firms were affected
 - SEC says “just over 2,300 firms de-registered”
 - Our number is 2,319

DATA



DEREGISTRATION

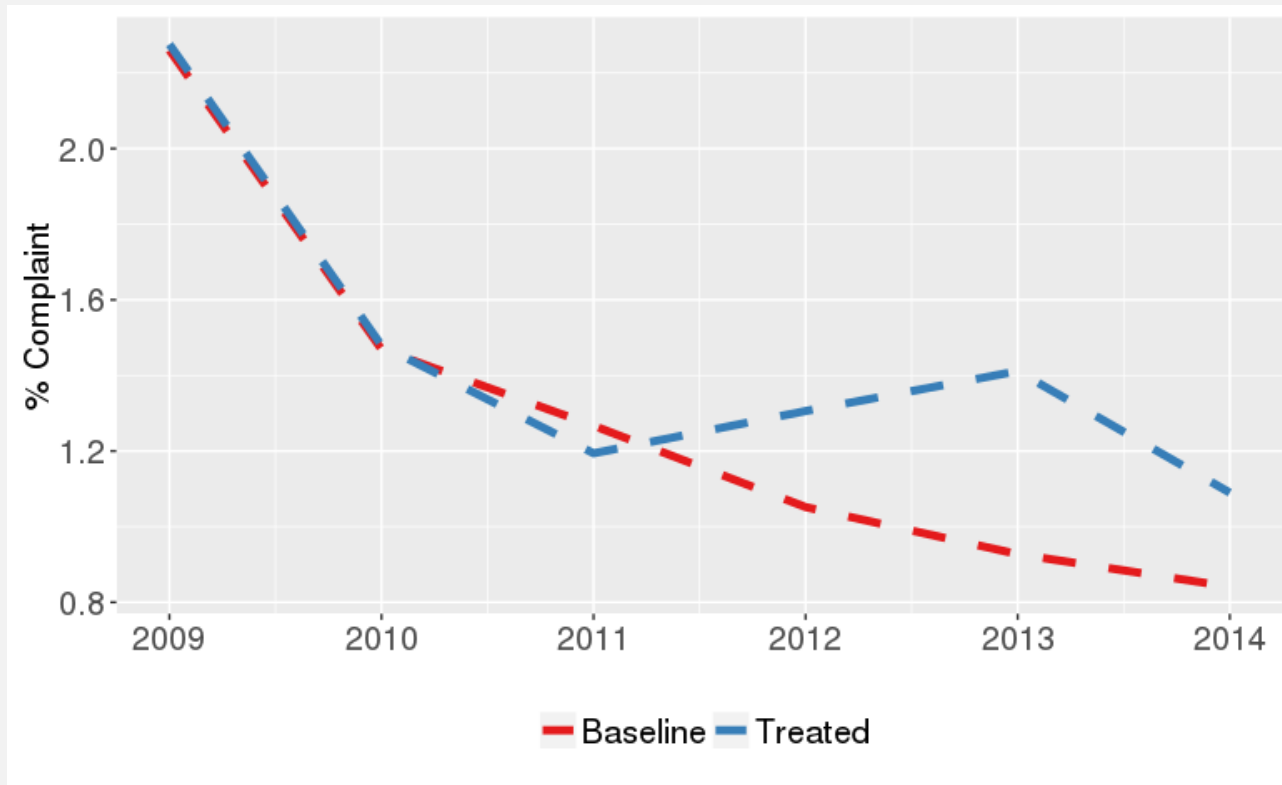
- Form ADV-W identifies de-registrants



ADVISER PUBLIC RECORD: EXAMPLES

Summary	Status Date	Type	Target
I made the mistake of purchasing 3 lbs of marijuana at an inexpensive price and was arrested in an undercover sting operation. I have lived a useful productive life since this time and am a law abiding member of society.	July 14, 1993	Criminal (Unrelated)	Representative
Offenses involved failures to comply with requirements relating to advertising of consumer credit products.	July 14, 1993	Criminal	Firm
Product: Equity. Alleged Damages: \$105,000. Settlement Amount: \$40,000. Employer: Merrill Lynch Pierce Fenner & Smith Inc. Client alleges that the financial advisor made misrepresentations, unsuitable investment recommendations and unauthorized trades.	May 11, 2009	Customer Dispute	Representative
The SAC manager defendants were indicted on felony charges of wire fraud in connection with the obtainment at various times from 1999 through 2010 of material nonpublic information for the purpose of executing securities transactions based on that inside information. Each SAC manager defendant was also separately indicted on a felony charge of securities fraud in connection with obtaining and trading on material nonpublic information at various times ranging from 1999 through 2010.	April 10, 2014	Criminal	Firm and Representatives

MAIN FINDINGS



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Treatment observations (**Medium size, 2012 onwards**):

- Non-treatment: **0.8% complaint rate**
- Treatment: **1.33% complaint rate**

Robust: Exclude California, NY, Wyoming, <\$100m, Exclude 2009

MAIN FINDINGS

Increase complaints for the following:

- Type of complaints: Mis-representation, Unauthorized, “Adviser”
- Type of complaints: Equity/Option investments
- Location: Older >60, Less educated, Further from regulatory office location
- Who: Those with prior track-record of complaints

ADDITIONAL FINDINGS: DAMAGES

- *Alleged Damages*: 22% to 67% higher
- Less likely to be *denied* damages
- *Awarded Damages*: Larger \$ damages recovered

INTERPRETATION

Supports the Misconduct hypothesis:

“State regulators are less effective at deterring misbehaviour than the SEC.”

- “Dodd-Frank weakened oversight of mid-sized RIA.”
- “...national regulators better deter financial misconduct.”

Consistent with **Agarwal, Lucca, Seru, and Trebbi (2014)** finding of better federal vs state regulators of banks.

INTERPRETATION

- Large geographical variation in enforcement effectiveness
- Funding seems to be an important component for many regulators
- But not clear what the policy implication is.
 - One suggestion may be: Make state regulators simply pay the federal-level SEC for more effective monitoring