

Assessing Risk using Self-Regulatory Organization Disclosures[☆]

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Abstract

We examine the effect of mandatory disclosure of misconduct on reputation management by firms and individual employees. Using a panel data set of Central Registration Depository public disclosures by financial advisors, we exploit a set of NASD/FINRA rule changes that substantially increased disclosure of past misconduct. In 2004, NASD Rule 2130 (later FINRA Rule 2080) prohibited expungement of misconduct records except for allegations that are clearly spurious and required judicial approval for all expungements. We find that prior to the 2004 rule change certain information useful for predicting future misconduct was obfuscated. However, even after the 2004 rule change, the expungement process still removed valuable information, and a later rule change did little to improve the situation. Using these changes in disclosure policy, we find that advisory firms are likely to dismiss employees for misconduct only when it is disclosed. Similarly, the labor market for advisors penalizes advisors only when an incident of misconduct is publicly disclosed - not for the misconduct itself.

Keywords: Advisors, Arbitration, Expungement, NASD, FINRA, Disclosure, Collective Reputation

JEL: G2, G20, G28, K2, K22

As of 2016, more than 643,000 individuals in the United States are employed as registered financial advisors in the financial advisory industry¹, and the overwhelming majority of individuals who participate in the equity market are advised by a financial advisors² (outside of employer sponsored retirement plans). Given the low level of financial literacy among households (e.g., Lusardi and Mitchell (2007)), financial advisors play a potentially important role helping households ensure long-term financial well-being and fund retirement. There is evidence, however, that many households do not accept financial advice because they do not trust financial advisors, and this lack of trust has an economically large effect on stock market participation and other financial behavior (Georgarakos and Inderst, 2014; Guiso, Sapienza, and Zingales, 2008). Moreover, empirical studies suggest that households' distrust of financial advisors has some justification. Bergstresser, Chalmers, and Tufano (2010) find that broker sold mutual funds have higher fees and inferior performance. Hackethal, Inderst, and Meyer (2011) find that investors who use an advisor incur significantly higher trading costs and disproportionately invest in products for which their advisor receives sales targets. Egan, Matvos, and Seru (forthcoming) find that a significant fraction of advisors engage in misconduct and recidivism rates are high. Market forces do not appear to eliminate misconduct in this industry. Only half of advisors lose their job after an incident of misconduct, and of those that do, a sizable fraction later find employment with other firms in the industry. Recent discussion papers by Campbell, Jackson, Madrian, and Tufano (2011) and Tufano (2009) stress the need for regulation in solving agency conflicts between advisors and their clients.

However, theory is less clear. Bolton, Freixas, and Shapiro (2007) argue that, under certain circumstances, reputation concerns can solve the principal-agent problem between advisors and their clients. In contrast, Carlin and Gervais (2012) and Inderst and Ottaviani (2009) argue that reputation concerns alone are insufficient to solve the principal-agent problems.

¹Source: FINRA's website <https://www.finra.org/newsroom/statistics>

²Source: 2011 Investment Company Institute Fact Book

Although theory does not unambiguously support the need for regulation, most countries regulate financial advisors. In the U.S., the cornerstone of the regulation of financial advisors is mandatory disclosure. Advisors and advisory firms are required to disclose information, including information about past customer complaints and regulatory sanctions. The purpose of these disclosures is twofold. First, this information allows potential clients to make informed decisions when selecting an advisor. Essentially mandatory disclosure provides information to clients with which to assess each advisor's reputation. Second, mandatory disclosure creates an *ex ante* disincentive for misconduct. Mandatory disclosure increases reputational penalties by making future complaints and regulatory actions clearly observable. As a result, advisors will reduce misconduct and advisory firms will increase their monitoring of employees.

Despite the economic importance of the financial advisory and the perceived importance of regulatory policy for this industry, in this paper, we provide some of the first empirical evidence on the role of market and regulatory forces in limiting agency problems in this industry. Specifically, we test the effects of rule changes that increased disclosure of past misconduct. We show that both advisors and advisory firms change their behavior as a result of increased mandatory disclosure: for example, mandatory disclosure increases the probability that an advisory firm will terminate an advisor for misconduct. However, even after the rule changes, expungements continue to predict future misconduct suggesting that information valuable for investor protection is still hidden by the expungement process.

We use a unique panel data set of advisor and advisory firms' mandatory disclosures filed with the National Association of Securities Dealers (NASD) and Financial Industry Regulatory Authority (FINRA). Each individual advisor must file disclosure forms and we are able to track individuals across different employers, and we observe information for all advisors working within a single advisory firm. This data set contains cases of regulatory sanctions, arbitration awards, private settlements, and client allegations of misconduct. Not all of these cases were publicly disclosed, however. Some customer complaints were allowed to be expunged. According to FINRA, information should be expunged only when it has

no meaningful investor protection or regulatory value. Once information is expunged, it is permanently deleted and thus no longer available to the investing public, regulators or prospective advisor employers.

In the first portion of the sample, expungement rules freely permitted non-disclosure for many cases, even when large damages were paid to clients. As part of settlement discussions, advisors were able to negotiate for customers to agree to expungement relief. Regulators expressed concern that advisor could buy a clean record. E.g., “Currently, it is possible that respondents may agree to pay damages as a quid pro quo for expungement and obtain court confirmation of the expungement.”³ In 2004, NASD Rule 2130 prohibited expungement except for allegations that are clearly spurious, and required judicial approval for all expungements. After this change concerns still persisted the arbitrators judgment when granting expungements. FINRA Rule 12805 established procedures that arbitrators must follow before recommending expungement of customer dispute information related to arbitration. We use these changes in disclosure requirements to identify how mandatory disclosure changes the reputational building behavior of individual advisors and of advisory firms.

We show that prior to the NASD 2130 rule change both expunged and disclosed misconduct predict future misconduct. Prior to the rule change, more expungements were granted and the relation between expungements and future misconduct was stronger than after suggesting that the rule change reduced the frequency of expungement of valuable information. However, even after the rule change, expungements predict future misconduct suggesting the advisors were still able to avoid disclosure of meaningful information. Furthermore, there are no significant effects due to the FINRA Rule 12805 change. In these tests, we control for potentially confounding factors by examining within firm-county-year variation. We also address other time-varying explanations by controlling for the advisor’s experience and specific licenses an advisor gains over time. These controls allow us to rule out alternative explanations based on changes in firm’s tolerance for misconduct, business lines, other regulatory changes, or economic conditions over time.

³<https://www.sec.gov/rules/sro/34-48933.htm>

Next, we show that advisory firms react to disclosed cases of misconduct by terminating the offending advisor. However, despite the fact that both expunged and disclosed misconduct have similar predictive power of future misconduct, there is no relation between expunged complaints and termination. Again in these tests, we control for firm-county-year fixed effects as well as the advisor’s experience and licensing history. Similarly, we examine the relation between misconduct and finding reemployment in the industry after separating from a firm. We find that disclosed misconduct hinders the search for future employment, while expunged misconduct does not. Finally, we examine whether the productivity of advisor can explain these relations and rule out that these effects are driven solely by advisors having more assets under management.

Despite the importance of the advisory industry to households’ financial well-being and numerous theoretical results suggesting that regulation is necessary in this industry, until recently little empirical research has focused on advisor misconduct. We build upon the finding in Egan, Matvos, and Seru (forthcoming) that firms, and more generally, the labor markets, discipline misconduct by financial advisors. We find that these mechanisms appear to function only when such misconduct is publicly disclosed suggesting the key role of reputation and its interaction with mandatory disclosure. We also add to the literature documenting different mechanisms that affect the prevalence of misconduct among financial advisors. Dimmock, Gerken, and Graham (forthcoming) provide evidence that misconduct is contagious spreading among geographically proximate co-workers within firms. Charoenwong, Kwan, and Umar (2017) suggest that the identity of the regulatory may be instrumental in deterring misconduct. Egan, Matvos, and Seru (2017) find disparities in labor market consequences for advisor misconduct across gender. The unique features of our data, namely the ability to observe disclosures (both those made public and those expunged) by all advisors within each advisory firm, allow us to observe the mechanism through which disclosure rules change behavior. We are able to show that disclosure increases the reputational costs to misconduct and causes firms to take actions to restore their reputations.

Our results compliment the growing number of theoretical models of agency problems in

this industry, such as: Bolton, Freixas, and Shapiro (2007), Carlin and Gervais (2012), and Inderst and Ottaviani (2009). Our results also contribute to the literature on the effects and usefulness of disclosure in financial markets. There is a vast literature on disclosure by public companies (e.g., Greenestone, Oyer, and Vissing-Jorgensen (2006); or Leuz and Wysocki (2008) for a survey of this literature). More recently, several papers have examined the importance of mandatory disclosures by asset management firms (e.g., Brown, Goetzmann, Liang, and Schwarz (2008); Dimmock and Gerken (2012)). We present the first empirical evidence as to the effect of mandated disclosure by advisors.

Our findings also speak to a more general literature on the disciplining effect of crime and misconduct disclosure on recidivism. Using the evolution of state law, Prescott and Rockoff (2011) find evidence that registration and notification of sex offenders reduces the frequency of sex offenses. Interestingly, much of the effect comes from increased deterrence among the non-registered population instead of reduced recidivism among registered offenders. Luca (2015) uses variation in the establishment of state-level online criminal databases and finds that the introduction of these records lead to a modest reduction in property crime, but marked increase in recidivism among known offenders. In our setting, we are able to track individual and observe both disclosed and undisclosed misconduct, and we find that disclosed misconduct hinders the search for future employment, while expunged misconduct does not.

The remainder of the paper is organized as follows. Section 1 describes the financial advisory industry. Section 2 details the disclosure system by financial advisory industry. Section 3 reviews the data and key variables. In Section 4, we examine past misconducts (both disclosed and expunged) ability to predict future misconduct. In Section 5, we examine how brokerage firms respond to disclosed cases. Section 6 examines how advisor productivity alters the relationships we document. Section 7 concludes.

1. The Financial Advisory Industry, Agency Conflicts, and Hypotheses

1.1. *Financial Advisors and the Advisory Industry*

Registered representatives, commonly referred to as financial advisors, are employees of advisory firms who are "... primarily securities salespeople..."⁴ Their job is to generate trading commissions and fees for their firm by selling financial products to their clients. The majority of advisors act as full-service brokers, meaning that they advise clients about asset allocation, security selection, and other matters. Some advisors are employees of a brokerage firm; others are independents, who are not employees but are affiliated with a brokerage firm that clears their clients' trades. In either case, their compensation is closely linked to the fees and commissions they generate.⁵

1.2. *Conflicts of Interest*

The link between advisors' compensation and the fees and commissions charged to the customer creates an agency problem. Advisors have an incentive to encourage excess trading or to recommend unsuitable products with high commissions. Hackethal, Inderst, and Meyer (2011) find that customers who rely heavily on their advisor pay substantially more in overall commissions than other customers. Bergstresser, Chalmers, and Tufano (2010) find that broker sold mutual funds have higher fees and significantly worse performance. Chalmers and Reuter (2015) find that broker advised investors earn have significantly worse risk adjusted returns than unadvised investors. While suggestive of opportunism that the agency relation creates, none of these studies provides direct evidence of misconduct by advisors.

Nearly all of the claims of misconduct that a customer can assert against an advisor derive from the legal concepts of fraud or negligence. The most common customer complaints of misconduct include unsuitability, unauthorized trading, churning, and misrepresentation or omission. Unsuitability occurs when an advisor advises his client to invest in assets that he knows are outside the client's risk tolerance or are not suited to meet the client's financial

⁴See the FINRA webpage: <http://www.finra.org/Investors/SmartInvesting/GettingStarted/SelectingInvestmentProfessional/P117278>

⁵http://registeredrep.com/research/broker-compensation-survey/finance_crisis_crisis/

goals. Unauthorized trading occurs when an advisor fails to obtain permission before buying or selling securities, or acts against a client's express instructions. Churning is the excessive buying and selling of securities in order to generate commissions. Misrepresentation or omission occurs when an advisor knowingly omits material facts about a security, or fails to offer material information regarding an investment opportunity. Note, advisors are not responsible if their investment advice simply turns out to be poor advice (e.g. an investment which the advisor recommended, in good faith, with full disclosure, did not prove to be profitable).

1.3. Solutions to the Agency Problem

Stigler (1964) argues that financial markets will find the optimal means to minimize agency problems. At best, regulation will require disclosures or actions the market would have produced regardless of regulation. More likely, he argues, regulation will impose costs that outweigh the benefits. Darby and Karni (1973) and Klein and Leffler (1981) argue that, under certain conditions, reputation can solve agency problems. Firms with good reputations can charge premium prices. Firms will invest in reputation so as to earn these economic rents. Following this logic, Bolton, Freixas, and Shapiro (2007) show that in some circumstances the combination of reputational concerns and competition can solve the principal-agent problem between advisors and their clients.

Others, however, argue that market forces alone cannot solve the agency problem in the advisory industry. Carlin and Gervais (2012) argue that regulation is necessary. Reputation is insufficient in the market for financial advice because of the difficulty in determining the *ex ante* quality of advice based on *ex post* outcomes. Inderst and Ottaviani (2009) argue that reputation cannot solve agency conflicts between advisors and their clients because of agency conflicts within financial services firms between advisors and advisory firms.

In the United States the financial advisory industry is subject to regulation and is monitored by the Securities and Exchange Commission (SEC). The SEC bans certain practices, requires brokers to understand their clients' needs and recommend only "suitable" products, and requires brokers to disclose certain information. The actual collection and dissemina-

tion of the disclosed information is implemented by self-regulatory organizations: originally NASD and now FINRA.

2. CRD Disclosure and NASD/FINRA Rule Changes

The Central Registration Depository (CRD) database is a joint venture between the U.S. securities industry, state and federal regulators, and the self-regulatory organization FINRA (and its predecessor NASD). The database contains records gathered from a host of regulatory filings such as Forms U4 and U5. These forms contains administrative information (e.g., personal, organizational, employment history, registration) and disclosure information (e.g., criminal records, regulatory actions, and information relating to customer disputes). Disclosure of data in the CRD must balance three competing interests: (1) the interests of NASD (and later FINRA) and state regulators in retaining broad access to customer dispute information to fulfill their regulatory responsibilities and investor protection obligations; (2) the interests of the financial advisory industry and its employees in a fair process that recognizes their stake in protecting their reputations and permits expungement from the CRD system when appropriate; and (3) the interests of investors in having access to accurate and meaningful information about advisors with whom they conduct, or may potentially conduct, business.

2.1. FINRA Rule 2080, formerly NASD Rule 2130

From the founding of the CRD in 1981 until 1999, the the process through which customer dispute information was expunged from an advisor's CRD record went unchanged. Expungement ordered by an arbitrator was afforded the same treatment as court-ordered expungement. In 1999, NASD imposed a moratorium on arbitrator awarded expungements. Finally, in 2004, NASD Rule 2130 put in place a new guidelines for expungement. FINRA Rule 2080 (formerly NASD Rule 2130) establishes conditions a arbitrator must find to expunge a customer dispute claim from the CRD system.

- the claim, allegation, or information is factually impossible or clearly erroneous

- the registered person was not involved in the alleged investment-related sales practice violation forgery, theft, misappropriation, or conversion of funds
- the claim, allegation, or information is false

In addition, FINRA Rule 2080 requires that FINRA be named as a party to the court proceedings, and be served with all appropriate documents.

2.2. FINRA Rule 12805

Even after NASD Rule 2130, concerns continued to grow as members of the industry observed more and more informal requests to consent to expungement as part of a settlement. FINRA Rule 12805 was put forth to combat these concerns and establish procedures that arbitrators must follow before recommending expungement of customer dispute information related to arbitration.

- Hold a recorded hearing session by telephone or in person
- In cases involving a settlement, review the settlement documents to examine the amount paid to any party and any other terms and conditions of the settlement
- Provide a brief written explanation of the reasons for ordering expungement
- Assess forum fees for hearing sessions held solely for the purpose of considering expungement against the parties requesting the relief

2.3. Hypotheses

In our study, we focus on the mandated disclosures collected in the CRD. Advisors must disclose information to FINRA on a regular basis, and FINRA provides online access to a subset of this information.⁶ FINRA states that “arbitrators should recommend expungement of customer dispute information only when it has no meaningful investor protection or regulatory value.” If the NASD and FINRA rule change had their intended effect of

⁶See: <http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/>

eliminating expungement of valuable information, then we should observe that expunged complaints should not predict future misconduct after the rule change. Suppose that the disclosed information is not redundant, meaning it would not be disclosed to clients in the absence of disclosure requirements. Then we would expect advisors and advisory firms to react differently to misconduct depending on whether or not it is disclosed. To protect its reputation, an advisory firm will be more likely to terminate an employee who discloses a case relative to an employee who commits a similar act that is not disclosed. We also expect and individual reemployment prospects after termination will be worse for disclosed versus non-disclosed misconduct.

The reaction of advisory firms to their employees' disclosure of misconduct should also vary based on the characteristics of the firm. As Tirole (1996) states, a firm's reputation is based in part on an "aggregate of individual reputations". Both the brokerage firm and the individual broker suffer a reputational penalty from disclosure. The fact that the broker does not pay the entire reputational penalty from disclosure creates a moral hazard problem. Inderst and Ottaviani (2009) show that brokers will behave less ethically than the brokerage firm would prefer, because the broker does not pay the full reputational penalty of misconduct. This wedge between the total reputational penalty and the reputational penalty of the broker will vary across firms. In a sole proprietorship the broker does bear the full reputational penalty. In a large firm the broker's share of the reputational penalty is smaller. Thus we expect brokerage firms' reaction to disclosure to vary depending on the firms' characteristics.

3. Industry Structure and Data

We collect data from FINRA's Brokercheck database for financial advisors in the United States.⁷ In sum, the data set contains approximately 1.2 million financial advisors and

⁷We also thank the state securities regulators from Alabama, Arkansas, California, Connecticut, Florida, Kentucky, Maryland, Michigan, Minnesota, Nevada, Pennsylvania, New York, Texas, Vermont, and Washington for providing the additional data on advisors that are registered in their respective states.

contains employment records that date back to 1939⁸. The disclosures based on FINRA Form U4 and U5 filings provide basic information (name, current/historical employers, licensing) about the advisors as well as client allegations of misconduct, regulatory sanctions, and arbitration awards.

However, not all client allegations of misconduct are recorded in the CRD database. Advisors may request that client allegations may be removed from the official record through the expungement process. Therefore, we augment the CRD data with NASD/FINRA arbitration awards available from the Westlaw International Database. By mapping the Westlaw case data to the individual's CRD number using the claimant and respondent fields in available in each data source, we are able to determine which customer complaints remain on CRD and which complaints were expunged. Although we carefully match by hand using advisor, firm name, and date, we are forced to discard some ambiguous cases. Other cases may fail to match due to clerical errors such as typos in names when the cases are entered into Westlaw.

We create an annual panel data representing the data that would have been available to someone using the BrokerCheck system on January 1st of each year and supplement it with the undisclosed expungement data from Westlaw. We begin the panel in 1999 to minimize survival bias as brokers that leave the industry remain in the system for a minimum of ten years. In certain tests, we also use a cross-section of assets under management (AUM) data available from Meridian IQ for a subset of advisors.

Table 1 Panel A contains summary statistics about the advisors in the sample. The typical advisor has worked for eleven years in the industry and passed 2.6 qualification exams that permit them to sell various financial products.

In Panel B, we examine misconduct, expungements, and employment around the three disclosure regimes during our sample. We use two measures of misconduct throughout. We follow the definition of misconduct in Egan, Matvos, and Seru (forthcoming), which includes customer dispute settlements and awards, regulatory disclosures, employment terminations,

⁸The data is survival-bias free for the prior 10 years

civil and criminal disclosures. One issue with using this metric to predict misconduct is that regulatory sanctions and terminations may result at a later date from an early misconduct, so future and past misconduct may be mechanically related in some cases. We also employ the measure in Dimmock, Gerken, and Graham (forthcoming), which is comprised of only customer dispute settlements and awards and thus less subject to this concern. As expected, the rate of expungements granted drops dramatically after the 2004 rule change. Not surprisingly, firm and industry turnover are higher in the periods that straddle the financial crisis.

4. Prediction of Future Misconduct

If disclosure of a past misconduct contains meaningful information about an advisor's willingness to exploit clients, then we expect past misconduct to predict future misconduct. Table 2 shows the estimates of linear probability models that use past misconduct to predict future misconduct.

The dependent variable is an indicator variable equaling one when the advisor engaged in misconduct in year t . *Past Expungement* is an indicator variable equaling one if the adviser has an incidence of misconduct prior to year t removed from the CRD database. *Past Misconduct* is an indicator variable equaling one if the adviser has a record of misconduct prior to year t in the CRD database. (We use the Egan, Matvos, and Seru (forthcoming) misconduct measure in Panel A of Table 2; we use the Dimmock, Gerken, and Graham (forthcoming) misconduct measure in Panel B of Table 2.) In some specifications, we also control for the advisor's experience and exam qualifications. In certain specifications, we also control for *Year* \times *Firm* \times *County* fixed effects. By controlling for these fixed effects, we account for the advisor's firm's time varying tolerance for misconduct, timing varying aggregate shocks such as the financial crisis, regulatory conditions that vary across time and geography, and local conditions that could affect demographics or labor market conditions in a certain county at a certain time. In all specifications, the significance tests are based on standard errors clustered by firm.

In column 1, we employ show that both disclosed past misconduct and having past expungements predicts future misconduct. In columns 2 and 3, we add the host of advisor-level controls. The results of both *Past Expungement* and *Past Misconduct* remain similar across these specifications. These results suggest that in our sample, expungement have significant predictive ability (in fact the magnitude of the coefficient is nearly as large as *Past Misconduct*). This is consistent with at least some of the cases being “whitewashed”. That is, these cases reflect negative information about the advisor (e.g. we find that these cases are related to higher propensity to engage in misconduct in the future), but this information was not available to customers through the industry’s disclosure system.

The fourth column, we add interaction based on the three disclosure regimes: Pre-NASD Rule 2130 (1999-2003), Pre-FINRA Rule 12805 (2004-2008), and Post-FINRA Rule 12805 (2009-2013). We define Post-FINRA Rule 12805 (2009-2013) as the base period and add interaction effects for the earlier periods - thus the coefficient of *Past Expungement* in column 4 can be interpreted as the coefficient during the 2009-2013 period. Notably, even after the two disclosure rule changes, expungements continue to significantly predict future wrongdoing. The large, positive and significant coefficient on *Past Expungement* \times *Pre-Rule 2130* suggests that expungements were even more strongly related to future misconduct before NASD Rule 2130 meaning that the rule did help to curtail the reduction of information caused by the expungement process. The insignificant coefficient on *Past Expungement* \times *Pre-Rule 12805* suggests that this rule did little to improve the expungement process.

5. How Brokerage Firms Respond to Disclosed Cases

A good reputation is a valuable asset. Advisory firms can take actions to protect and maintain their reputations. In addition to monitoring and other activities to prevent misconduct, advisory firms can engage in reputation management activities after complaint cases. Following a case against one of its advisors, an advisory firm can terminate the offending advisor. This shows clients that the firm is concerned with its reputation and potentially reduces reputational penalties.

Advisory firms observe all complaints and cases involving their employees, regardless of whether the complaint is expunged or disclosed. Table 2 shows that the information content of expunged and disclosed cases is similar: both types of cases predict future misconduct. Thus from the firm’s perspective both types of cases contain similar information about the advisor’s character and practices. If firms are concerned with preventing future misconduct by their employees, we would expect firms to have similar reactions to disclosed and expunged complaints. However, if mandatory disclosure provides clients with information that would otherwise be hidden, then disclosed and expunged cases have different reputation costs. Each advisory firm must disclose the cases that its advisors disclose. If a firm fires the offending advisor, the firm can cease disclosing the case after two years. The firm can also state in its disclosures that the advisor is no longer with the firm, further minimizing the reputational cost.

In this section, we test whether advisory firms react differently to disclosed cases versus expunged cases. Specifically, we test whether firms react to cases by separating from advisors. Table 3 shows the results of linear probability models that predict whether an advisor leaves his employer in the subsequent year, $t+1$. In these models are key variables are whether an advisor engages in *Expungement* or *Misconduct* in year t .

As with the prior table, columns 1, 2, and 3 of Table 4, report specifications of the key variables, *Expungement* or *Misconduct*, with various sets of controls. (Also as with the prior table, panels A and B report results using the Egan, Matvos, and Seru (forthcoming) and Dimmock, Gerken, and Graham (forthcoming), respectively.) In each case, there is a strong negative effect of *Misconduct* on whether the advisor is employed with the firm next year. Interestingly, no negative effect of *Expungement* (and, in fact, the coefficient is positive in several specifications) on whether the advisor is retained. There are no notable changes in reaction to expungement across the various disclosure regimes in column 4. Collectively, these results suggest a strong divergence in how firm react to disclosed versus non-disclosed misconduct, despite the fact that both types of events have a similar relation with future misconduct.

We interpret this as evidence that mandatory disclosure changes the behavior of firms. Mandatory disclosure increases the reputational penalty of misconduct. As a result, advisory firms act to restore their reputations by firing advisors. The insignificant results for expunged complaints suggest that it is the disclosure of misconduct, not the misconduct itself that prompts termination.

We next examine how the labor market disciplines disclosed versus expunged misconduct. We consider the sample of advisors who leave their firm in year t . We ask does having disclosed and/or expunged misconduct affect job market prospects.

In Table 4, we report linear probability models of employment (at any firm) in the next year for this sample of dismissed advisors. As before, we employ two key variables, *Expungement* and *Misconduct*. Again across all specifications, we find little negative effect on job market prospects from incurring an expungement despite its predictive nature of future wrongdoing. This suggests that at the industry level having an expungement is not particularly detrimental, especially compared to some types of reported misconduct.

6. Alternate Explanation: Advisor Productivity

One concern is that expungements could be frivolous claims by investors and that advisors with more clients with more assets under management are more likely to be subjected to false claims and thus next to use the expungement process. To examine this alternative explanation, we obtain assets under management data from Meridian IQ for a subset of advisors in 2014.

In Table 5, we examine the relation between misconduct and assets under management. In column 1, we estimate a linear regression where the dependent variable is the assets under management. Note, we only have AUM data for 2014. We find advisors with a history of expungements have \$17.7 million more in AUM than advisors without. For reference, the average advisor has \$68.5 million in assets under management. These results should not be interpreted casually. It is unlikely that investors invest more with an advisor if they have such a history. Instead, it is likely that advisors with significant assets under management

may be more willing settle (and expunge) to avoid negative marks on their records. Because of the potential confounding variation, we again estimate our main predictive regressions with an additional fixed effect for the level (decile) of AUM an advisor has. We report these results in columns 2 and 3. Importantly, the results are qualitatively similar after including this control for AUM suggesting that advisor productivity cannot fully explain the relation.

7. Conclusion

Using a dataset of misconduct disclosures by financial advisers, we examine the effect of mandatory disclosure on reputation management by firms and individual employees. Given the low level of financial literacy among households, these advisors play a potentially important role helping households ensure long-term financial well-being and fund retirement. As many households do not accept financial advice because they do not trust financial advisors, understanding the efficacy of the existing system of regulation which is based on disclosure is of primary importance.

Using a series of shifts in misconduct disclosure policy due to NASD/FINRA rule changes, we find that certain information useful for predicting future misconduct was obfuscated and to a lesser degree continues to remain obscured. These rule changes also allow us to examine reputation management among firms in the industry. By examining both the act of misconduct itself and the disclosure of the act, we find that advisory firms are more likely to let go employees for misconduct when it is disclosed, but not if the act is not disclosed. This result is consistent with the management of reputation by firms.

Our results contribute to the literature on the effects and usefulness of disclosure in financial markets. We also document that disclosure increases the reputational costs to misconduct and causes firms and employees to take actions to restore their reputations.

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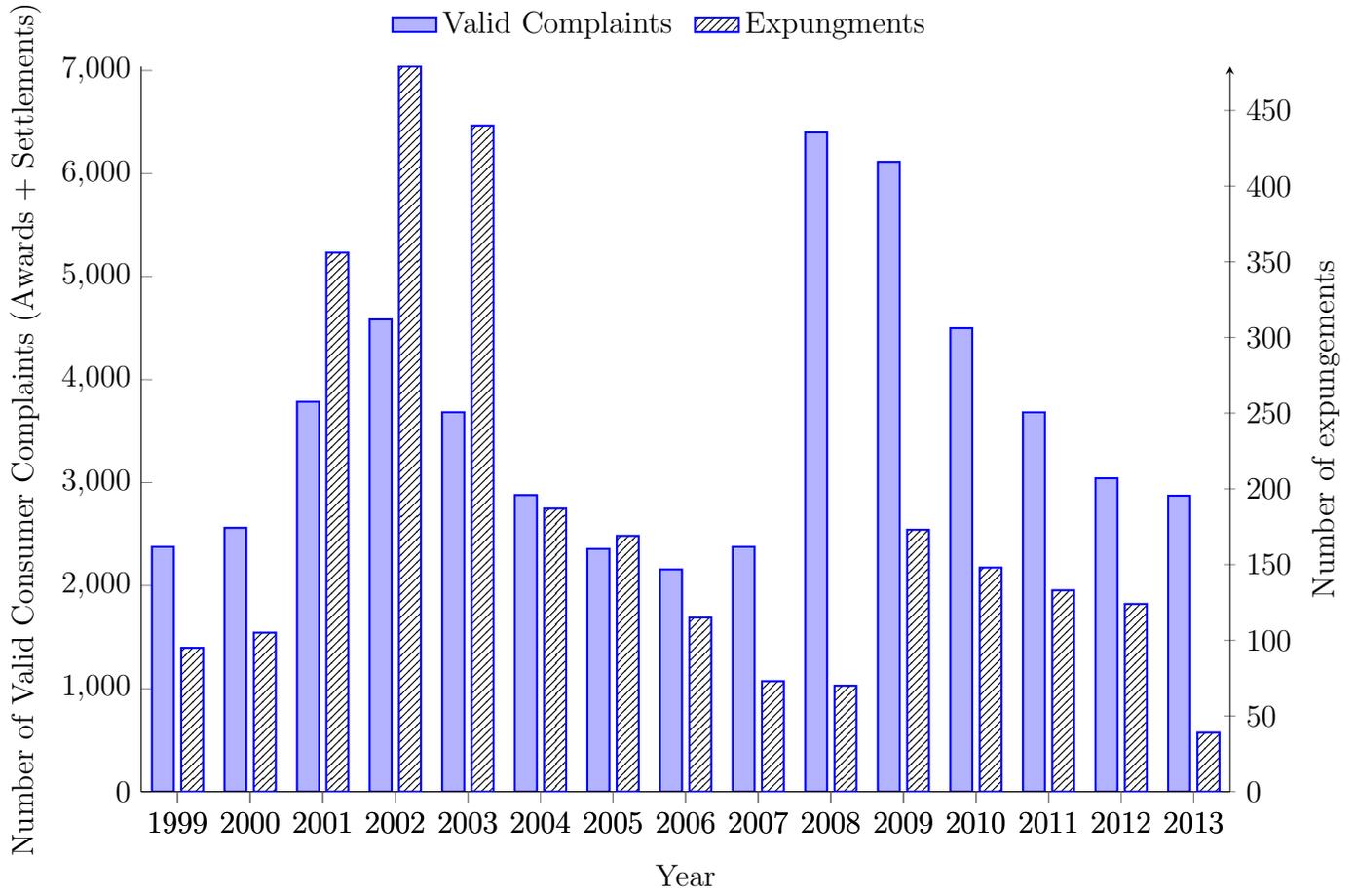


Figure 1
 Number of FINRA Occurences by Year

Table 1

Summary Statistics

Panel A provides advisor-year level summary statistics. We begin the panel data set in 1999 and record variables as of January 1st of each year through 2013. Panel B reports misconduct, expungements, and employment changes by regulatory regime during our sample. In column 1, we measure misconduct using the definition in Egan, Matvos, and Seru (forthcoming). In column 2, we measure misconduct using the definition in Dimmock, Gerken, and Graham (forthcoming). Expungement are customer complaints that went to arbitration but are not disclosed on the advisor's CRD record.

Panel A: Advisor Summary Statistics			
Variable	Obs	Mean	Std. Dev.
Experience (years)	11,121,393	11.5	8.9
Total exams	11,121,393	2.6	1.3
Securities Agent State Law (Series 63)	11,121,393	0.743	0.437
General Securities Rep. (Series 7)	11,121,393	0.607	0.489
Investment Co. Product Rep. (Series 6)	11,121,393	0.392	0.488
Investment Adviser Exam (Series 65/66)	11,121,393	0.289	0.453
General Securities Principal (Series 24)	11,121,393	0.122	0.328
Asset under management (\$M) [2012 only]	303,450	68.5	151.9

Panel B: Misconduct by Period						
		Misconduct (EMS)	Misconduct (DGG)	Expungement	Exit Firm	Exit Industry
Pre-NASD 2130 (1999-2003)	Rule	0.90%	0.64%	0.06%	14.70%	3.97%
Pre-FINRA 12805 (2004-2008)	Rule	0.62%	0.42%	0.02%	17.61%	7.45%
Post-FINRA 12805 (2009-2013)	Rule	0.75%	0.42%	0.02%	18.31%	10.35%
Full Sample		0.74%	0.48%	0.03%	17.12%	7.65%

Table 2

Predicting Future Misconduct with Past Misconduct and Expungements

This table reports regression results for linear probability models on the sample of financial advisor-years from 1999 to 2013. In Panel A, we measure misconduct using the definition in Egan, Matvos, and Seru (forthcoming). In Panel B, we measure misconduct using the definition in Dimmock, Gerken, and Graham (forthcoming). The dependent variable equals one if the broker engages in misconduct in the subsequent year. The independent variable for *Past Misconduct* equals one if the advisors has any prior record of misconduct. *Expungement* equals one if the advisor has had any prior complaint expunged from his record. *Experience* is the number of years the advisor has worked in the industry. *Investment Adviser Exam (Series 65/66)* equals one if the advisor has passed the Series 65 or Series 66 exam. *General Securities Principal (Series 24)* equals one if the advisor has passed the Series 24 exam. *General Securities Rep. (Series 7)* equals one if the advisor has passed the Series 7 exam. *Investment Co. Product Rep. (Series 6)* equals one if the advisor has passed the Series 6 exam. *Securities Agent State Law (Series 63)* equals one if the advisor has passed the Series 63 exam. *# of Other Exams Passed* is the sum of other qualification exams the advisor has passed. *Pre-Rule 2130 (1999-2003)* is an indicator for the period before Rule 2130 came into effect. *Pre-Rule 12805 (2004-2008)* is an indicator for the period years after Rule 2130, but before Rule 12805 came into effect. In columns 3 and 4, the regression also includes year-firm-county fixed effects. Standard errors are clustered by firm. Z-scores are reported in square brackets. The symbols *, **, and *** denote significance at the 10%, 5%, and 1% levels, respectively.

Panel A: Misconduct defined as in Egan, Matvos, and Seru (forthcoming)				
	(1)	(2)	(3)	(4)
Past Expungement	0.0255***	0.0237***	0.0225***	0.0203***
	[9.439]	[8.723]	[9.039]	[6.460]
×Pre-Rule 2130 (1999-2003)				0.0262***
				[3.428]
×Pre-Rule 12805 (2004-2008)				-0.0005
				[-0.141]
Past Misconduct	0.0351***	0.0332***	0.0265***	0.0267***
	[30.758]	[28.380]	[38.315]	[18.606]
×Pre-Rule 2130 (1999-2003)				0.0020
				[1.012]
×Pre-Rule 12805 (2004-2008)				-0.0022
				[-1.341]
Experience		0.0001***	0.0001***	0.0001***
		[3.276]	[10.375]	[10.413]
Invest. Adviser Exam (Series 65/66)		0.0038***	0.0038***	0.0038***
		[9.237]	[9.464]	[9.437]
Securities Agent State Law (Series 63)		0.0024***	0.0022***	0.0022***
		[8.860]	[8.805]	[8.700]
General Securities Rep. (Series 7)		0.0011***	0.0017***	0.0017***
		[4.156]	[6.582]	[6.569]
Invest. Co. Product Rep. (Series 6)		-0.0003	0.0008***	0.0009***
		[-0.838]	[4.070]	[4.057]
General Securities Principal (Series 24)		0.0011***	0.0008***	0.0008***
		[2.726]	[3.146]	[3.158]
# of Other Exams Passed		-0.0001	-0.0001*	-0.0001*
		[-0.718]	[-1.763]	[-1.786]
Year×Firm×County Fixed Effect	No	No	Yes	Yes
Observations	8,604,225	8,604,225	8,314,263	8,314,263
R^2	0.009	0.010	0.088	0.088

Panel B: Misconduct defined as in Dimmock, Gerken, and Graham (forthcoming)				
	(1)	(2)	(3)	(4)
Past Expungement	0.0203***	0.0184***	0.0178***	0.0161***
	[10.462]	[9.362]	[9.579]	[7.031]
×Pre-Rule 2130 (1999-2003)				0.0241***
				[3.286]
×Pre-Rule 12805 (2004-2008)				-0.0004
				[-0.150]
Past Misconduct	0.0304***	0.0280***	0.0247***	0.0221***
	[29.499]	[27.362]	[32.563]	[15.882]
×Pre-Rule 2130 (1999-2003)				0.0129***
				[6.959]
×Pre-Rule 12805 (2004-2008)				-0.0011
				[-0.645]
Experience		0.0001***	0.0001***	0.0001***
		[9.578]	[11.485]	[11.494]
Invest. Adviser Exam (Series 65/66)		0.0034***	0.0033***	0.0033***
		[9.498]	[8.906]	[9.026]
Securities Agent State Law (Series 63)		0.0021***	0.0017***	0.0018***
		[9.567]	[8.223]	[8.268]
General Securities Rep. (Series 7)		0.0014***	0.0014***	0.0015***
		[6.894]	[5.286]	[5.422]
Invest. Co. Product Rep. (Series 6)		-0.0006**	0.0005***	0.0005***
		[-2.226]	[3.014]	[3.190]
General Securities Principal (Series 24)		-0.0004	-0.0000	-0.0000
		[-1.037]	[-0.082]	[-0.008]
# of Other Exams Passed		-0.0001	-0.0002***	-0.0002***
		[-0.914]	[-3.664]	[-4.097]
Year×Firm×County Fixed Effect	No	No	Yes	Yes
Observations	8,604,225	8,604,225	8,314,263	8,314,263
R^2	0.007	0.009	0.078	0.078

Table 3

Misconduct, Expunged Records, and Probability the Advisor Stays the Firm

This table reports regression results for linear probability model on the sample of financial advisor-years from 1999 to 2013. In Panel A, we measure misconduct using the definition in Egan, Matvos, and Seru (forthcoming). In Panel B, we measure misconduct using the definition in Dimmock, Gerken, and Graham (forthcoming). The dependent variable equals one if the advisors stays with the firm in the subsequent year. The independent variable for *Past Misconduct* equals one if the advisors has any prior record of misconduct. *Expungement* equals one if the advisor has had any prior complaint expunged from his record. *Experience* is the number of years the advisor has worked in the industry. *Investment Adviser Exam (Series 65/66)* equals one if the advisor has passed the Series 65 or Series 66 exam. *General Securities Principal (Series 24)* equals one if the advisor has passed the Series 24 exam. *General Securities Rep. (Series 7)* equals one if the advisor has passed the Series 7 exam. *Investment Co. Product Rep. (Series 6)* equals one if the advisor has passed the Series 6 exam. *Securities Agent State Law (Series 63)* equals one if the advisor has passed the Series 63 exam. *# of Other Exams Passed* is the total number of qualification exams the advisor has passed. *Pre-Rule 2130 (1999-2003)* is an indicator for the period before Rule 2130 came into effect. *Pre-Rule 12805 (2004-2008)* is is an indicator for the period years after Rule 2130, but before Rule 12805 came into effect. In columns 3 and 4, the regression also includes year-firm-county fixed effects. Standard errors are clustered by firm. Z-scores are reported in square brackets. The symbols *, **, and *** denote significance at the 10%, 5%, and 1% levels, respectively.

Panel A: Misconduct defined as in Egan, Matvos, and Seru (forthcoming)				
	(1)	(2)	(3)	(4)
Expungement	-0.0069	-0.0171	0.0085	0.0034
	[-0.412]	[-1.136]	[1.268]	[0.235]
×Pre-Rule 2130 (1999-2003)				0.0182
				[1.175]
×Pre-Rule 12805 (2004-2008)				-0.0222
				[-1.084]
Misconduct	-0.0721***	-0.0873***	-0.0487***	-0.0435***
	[-8.294]	[-12.879]	[-15.446]	[-8.169]
×Pre-Rule 2130 (1999-2003)				-0.0074
				[-0.830]
×Pre-Rule 12805 (2004-2008)				-0.0080
				[-1.280]
Experience		0.0035***	0.0028***	0.0028***
		[10.305]	[17.023]	[17.026]
Invest. Adviser Exam (Series 65/66)		0.0032	-0.0155***	-0.0155***
		[0.493]	[-4.524]	[-4.524]
Securities Agent State Law (Series 63)		0.0250***	0.0049**	0.0049**
		[4.628]	[1.961]	[1.961]
General Securities Rep. (Series 7)		0.0138*	0.0080***	0.0080***
		[1.694]	[3.028]	[3.029]
Invest. Co. Product Rep. (Series 6)		0.0311***	0.0154***	0.0154***
		[4.199]	[5.444]	[5.442]
General Sec. Principal (Series 24)		0.0030	0.0123***	0.0123***
		[0.363]	[5.155]	[5.154]
# of Other Exams Passed		-0.0034	-0.0002	-0.0002
		[-1.447]	[-0.380]	[-0.379]
Year×Firm×County Fixed Effect	No	No	Yes	Yes
Observations	8,604,225	8,604,225	8,314,263	8,314,263
R^2	0.000	0.008	0.340	0.340

Panel B: Misconduct defined as in Dimmock, Gerken, and Graham (forthcoming)				
	(1)	(2)	(3)	(4)
Expungement	0.0164	0.0052	0.0239***	0.0256*
	[1.029]	[0.368]	[3.371]	[1.758]
×Pre-Rule 2130 (1999-2003)				0.0018
				[0.112]
×Pre-Rule 12805 (2004-2008)				-0.0302
				[-1.447]
Misconduct	-0.2353***	-0.2479***	-0.1707***	-0.2473***
	[-15.944]	[-17.187]	[-15.400]	[-12.512]
×Pre-Rule 2130 (1999-2003)				0.1493***
				[7.049]
×Pre-Rule 12805 (2004-2008)				0.0947***
				[4.894]
Experience		0.0035***	0.0029***	0.0029***
		[10.454]	[17.202]	[17.227]
Invest. Adviser Exam (Series 65/66)		0.0039	-0.0150***	-0.0149***
		[0.601]	[-4.387]	[-4.366]
Securities Agent State Law (Series 63)		0.0254***	0.0052**	0.0052**
		[4.728]	[2.079]	[2.081]
General Securities Rep. (Series 7)		0.0138*	0.0081***	0.0082***
		[1.703]	[3.095]	[3.114]
Invest. Co. Product Rep. (Series 6)		0.0309***	0.0154***	0.0155***
		[4.183]	[5.467]	[5.485]
General Sec. Principal (Series 24)		0.0033	0.0124***	0.0124***
		[0.398]	[5.213]	[5.217]
# of Other Exams Passed		-0.0033	-0.0002	-0.0002
		[-1.420]	[-0.337]	[-0.375]
Year×Firm×County Fixed Effect	No	No	Yes	Yes
Observations	8,604,225	8,604,225	8,314,263	8,314,263
R^2	0.003	0.011	0.341	0.341

Table 4

Expunged Records and Probability the Advisor Remains the Industry

This table reports regression results for linear probability model on the sample of financial advisor-years from 1999 to 2013 that left their firm in the year. In Panel A, we measure misconduct using the definition in Egan, Matvos, and Seru (forthcoming). In Panel B, we measure misconduct using the definition in Dimmock, Gerken, and Graham (forthcoming). The dependent variable equals one if the advisor find work at another firm in the subsequent year. The independent variable for *Misconduct* equals one if the advisors has any prior record of misconduct. *Expungement* equals one if the advisor has had any prior complaint expunged from his record. *Experience* is the number of years the advisor has worked in the industry. *Investment Adviser Exam (Series 65/66)* equals one if the advisor has passed the Series 65 or Series 66 exam. *General Securities Principal (Series 24)* equals one if the advisor has passed the Series 24 exam. *General Securities Rep. (Series 7)* equals one if the advisor has passed the Series 7 exam. *Investment Co. Product Rep. (Series 6)* equals one if the advisor has passed the Series 6 exam. *Securities Agent State Law (Series 63)* equals one if the advisor has passed the Series 63 exam. *# of Other Exams Passed* is the total number of qualification exams the advisor has passed. *Pre-Rule 2130 (1999-2003)* is an indicator for the period before Rule 2130 came into effect. *Pre-Rule 12805 (2004-2008)* is an indicator for the period years after Rule 2130, but before Rule 12805 came into effect. In columns 3 and 4, the regression also includes year-firm-county fixed effects. Standard errors are clustered by firm. Z-scores are reported in square brackets. The symbols *, **, and *** denote significance at the 10%, 5%, and 1% levels, respectively.

Panel A: Misconduct defined as in Egan, Matvos, and Seru (forthcoming)				
	(1)	(2)	(3)	(4)
Expungement	0.1801*** [6.647]	0.1125*** [4.712]	0.0279 [1.443]	0.0179 [0.515]
×Pre-Rule 2130 (1999-2003)				0.0357 [0.877]
×Pre-Rule 12805 (2004-2008)				-0.0542 [-1.133]
Misconduct	-0.0911*** [-4.105]	-0.1298*** [-7.525]	-0.0478*** [-6.357]	-0.0770*** [-6.836]
×Pre-Rule 2130 (1999-2003)				0.0694*** [5.319]
×Pre-Rule 12805 (2004-2008)				0.0350*** [2.618]
Experience		0.0009 [1.544]	0.0003* [1.662]	0.0003* [1.678]
Invest. Adviser Exam (Series 65/66)		0.0877*** [7.396]	0.0403*** [11.077]	0.0403*** [11.099]
Securities Agent State Law (Series 63)		0.0780*** [8.713]	0.0630*** [22.729]	0.0631*** [22.728]
General Securities Rep. (Series 7)		0.1730*** [11.079]	0.1169*** [20.573]	0.1170*** [20.585]
Invest. Co. Product Rep. (Series 6)		0.0128 [0.801]	0.0470*** [10.434]	0.0470*** [10.450]
General Sec. Principal (Series 24)		-0.0317** [-2.134]	-0.0374*** [-11.161]	-0.0374*** [-11.158]
# of Other Exams Passed		0.0187*** [4.020]	0.0126*** [12.425]	0.0126*** [12.411]
Year×Firm×County Fixed Effect	No	No	Yes	Yes
Observations	1,473,317	1,473,317	1,372,853	1,372,853
R^2	0.001	0.061	0.468	0.468

Panel B: Misconduct defined as in Dimmock, Gerken, and Graham (forthcoming)				
	(1)	(2)	(3)	(4)
Expungement	0.1420***	0.0800***	0.0146	0.0071
	[5.189]	[3.284]	[0.750]	[0.204]
×Pre-Rule 2130 (1999-2003)				0.0380
				[0.924]
×Pre-Rule 12805 (2004-2008)				-0.0624
				[-1.289]
Misconduct	0.1371***	0.0631***	0.0396***	0.0157*
	[9.436]	[6.674]	[7.328]	[1.743]
×Pre-Rule 2130 (1999-2003)				0.0317***
				[2.757]
×Pre-Rule 12805 (2004-2008)				0.0403***
				[3.124]
Experience		0.0008	0.0003	0.0003
		[1.362]	[1.408]	[1.419]
Invest. Adviser Exam (Series 65/66)		0.0859***	0.0396***	0.0396***
		[7.253]	[10.997]	[10.999]
Securities Agent State Law (Series 63)		0.0766***	0.0626***	0.0626***
		[8.548]	[22.503]	[22.500]
General Securities Rep. (Series 7)		0.1726***	0.1167***	0.1167***
		[11.061]	[20.549]	[20.546]
Invest. Co. Product Rep. (Series 6)		0.0127	0.0469***	0.0469***
		[0.795]	[10.424]	[10.421]
General Sec. Principal (Series 24)		-0.0322**	-0.0375***	-0.0375***
		[-2.168]	[-11.287]	[-11.284]
# of Other Exams Passed		0.0188***	0.0127***	0.0127***
		[4.054]	[12.481]	[12.478]
Year×Firm×County Fixed Effect	No	No	Yes	Yes
Observations	1,473,317	1,473,317	1,372,853	1,372,853
R^2	0.001	0.060	0.468	0.468

Table 5

Advisor Productivity

This table reports regression results. In column 1, we report the results of a linear regressions where the dependent variable is the AUM reported by Meridian IQ for a subset of financial advisors. The data are only available for a single cross-section in 2014. In column 2, we report results from a linear probability model where the dependent variable is misconduct using the definition in Egan, Matvos, and Seru (forthcoming). In column 3, we report results from a linear probability model where the dependent variable is the definition in Dimmock, Gerken, and Graham (forthcoming). *Past Expungement* equals one if the advisor has had any prior complaint expunged from his record. *Experience* is the number of years the advisor has worked in the industry. *Investment Adviser Exam (Series 65/66)* equals one if the advisor has passed the Series 65 or Series 66 exam. *General Securities Principal (Series 24)* equals one if the advisor has passed the Series 24 exam. *General Securities Rep. (Series 7)* equals one if the advisor has passed the Series 7 exam. *Investment Co. Product Rep. (Series 6)* equals one if the advisor has passed the Series 6 exam. *Securities Agent State Law (Series 63)* equals one if the advisor has passed the Series 63 exam. *# of Other Exams Passed* is the total number of qualification exams the advisor has passed. In columns 2 and 3, the regression also includes AUM decile fixed effects, where AUM is obtained for a subset of advisors by Meridian IQ. In all specifications, the regression also includes year-firm-county fixed effects. Standard errors are clustered by firm. Z-scores are reported in square brackets. The symbols *, **, and *** denote significance at the 10%, 5%, and 1% levels, respectively.

Dependent Variable =	(1) AUM	(2) Misconduct (EMS)	(3) Misconduct (DGG)
Past Expungement	17.7047** [2.497]	0.0163*** [8.296]	0.0135*** [8.345]
Past Misconduct (EMS)	9.5598*** [5.112]	0.0240*** [29.562]	
Past Misconduct (DGG)			0.0216*** [27.246]
Experience	1.7760*** [12.093]	0.0002*** [9.647]	0.0002*** [9.656]
Investment Adviser Exam (Series 65/66)	8.0740*** [3.795]	0.0035*** [7.367]	0.0031*** [7.458]
Securities Agent State Law (Series 63)	3.3399*** [2.953]	0.0021*** [6.658]	0.0021*** [8.180]
General Securities Rep. (Series 7)	6.0044*** [3.379]	0.0017*** [4.010]	0.0015*** [3.754]
Investment Co. Product Rep. (Series 6)	-3.3375*** [-2.607]	0.0005* [1.882]	0.0003 [1.325]
General Securities Principal (Series 24)	-2.5353 [-1.139]	0.0001 [0.432]	-0.0002 [-0.654]
# of Other Exams Passed		-0.0001* [-1.709]	-0.0001** [-2.141]
AUM Decile Fixed Effects	No	Yes	Yes
Year×Firm×County Fixed Effect	Yes	Yes	Yes
Observations	282,387	3,380,361	3,380,361
R^2	0.075	0.097	0.092