The Vetting

How to investigate financial professionals – and why you should

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DISCLAIMER

The statements contained in this presentation are my own. They do not necessarily reflect the position of the Securities Commissioner or the State Securities Board.

- The importance of vetting financial professionals
- Financial adviser misconduct: How widespread?
- The case for ongoing due diligence

Public Funds
Public Officials
Public Trust

Investment advisers and broker-dealers work in the **private sector**, but there is an abundance of background information about them in the **public domain**

Overview of State Securities Regulation

Before being allowed to do business in states, broker-dealer and investment adviser firms, and their agents and representatives, are required to:

- ❑ apply for registration;
- ❑ submit to an extensive background check;
- ❑ pass examinations on securities law and principles; and
- ❑ agree to comply with certain record-keeping and disclosure requirements.

Overview of State Securities Regulation

REGISTRATION REQUIREMENTS. Promoters who offer and sell securities to the public are generally **required to comply with state laws that require the registration of securities and the licensing of dealers and their agents**.

- Securities regulators in Texas proactively review securities offerings to ensure that they are fair, just and equitable.
- Examiners also periodically inspect registrants to ensure they are adhering to supervisory procedures and complying with appropriate legal standards.
- Registration requirements generally apply to all persons and entities involved in the offer and sale of securities in Texas, as well as all securities offered in Texas.

Regulatory Oversight

Investment advisers are regulated by states or federal government depending on the amount of assets under management:

- ❑ State if AUM < $100 million

- ❑ SEC if AUM > $100 million

Investigative Resources

- ❑ BrokerCheck (FINRA)

- ❑ Investment Adviser Public Disclosure (Securities and Exchange Commission)

- ❑ **C**entral **R**egistration **D**epository – access through request to state

Researching a Broker

brokercheck.finra.org

FINRA's BrokerCheck holds licensing and registration information for registered representatives and securities dealers and brokerage firms in the U.S.

- ❑ Employment history for past 10 years
- ❑ Disciplinary actions
- ❑ Whether individuals holds other professional designations
- ❑ Civil judgments and arbitrations

Researching a Broker

- ❑ Pending written complaints
- ❑ Criminal convictions or indictments
- ❑ Bankruptcy filings
- ❑ Outstanding liens and judgments

Things may be missing, however. . .

Researching a Broker

Uncommon, but not all disciplinary actions and other red flags are reported right away.

Failure to report relevant information in a timely way generally violates securities laws

Expungement of FINRA Records

Time period: 2007-2016

Expungement attempts: 6,700 (12% of allegations of misconduct reported by customers and firms)

70% of expungement attempts successful

Honigsberg, Colleen, and Jacob, Matthew. "Deleting Misconduct: The Expungement of BrokerCheck Records," November 14, 2018, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3284738

Expungement of FINRA Records

Prior offenders more times as likely to engage in new misconduct as the average broker

State regulators and investor advocates:

Expungement removes legitimate allegations of misconduct and disciplinary infractions

Broker advocates:

Expungement is legitimate way to remove allegations that are without merit

IAPD www.adviserinfo.sec.gov

Form ADV: Essential Adviser Information

- ❑ Business practices
- ❑ Fees and compensation
- ❑ Multiple costs folded into 'wrap fee'
- ❑ Conflicts of interest
- ❑ Types of clients
- ❑ Disciplinary information
- ❑ Financial information about firm

Central Registration Depository

- Consolidation of state and federal filings
- Developed by North American Securities Administrators Association and FINRA in 1981
- Continuously updated
- Reporting standards subject to rule changes
- May contain information not found in BrokerCheck

Financial Adviser Misconduct: How Widespread?

Dataset of 1.2 million broker-dealers and investment advisers dually registered as broker-dealers (referred to here as “advisers”) registered in the U.S. **2005-2015**

Egan, Mark, Gregor Matvos, and Amit Seru. "The Market for Financial Adviser Misconduct." *Journal of Political Economy* 127, No. 1 (February 2019): 233–295.

Adviser Misconduct: How Widespread?

23 categories of disclosure – not all indicative of fraud or wrongdoing

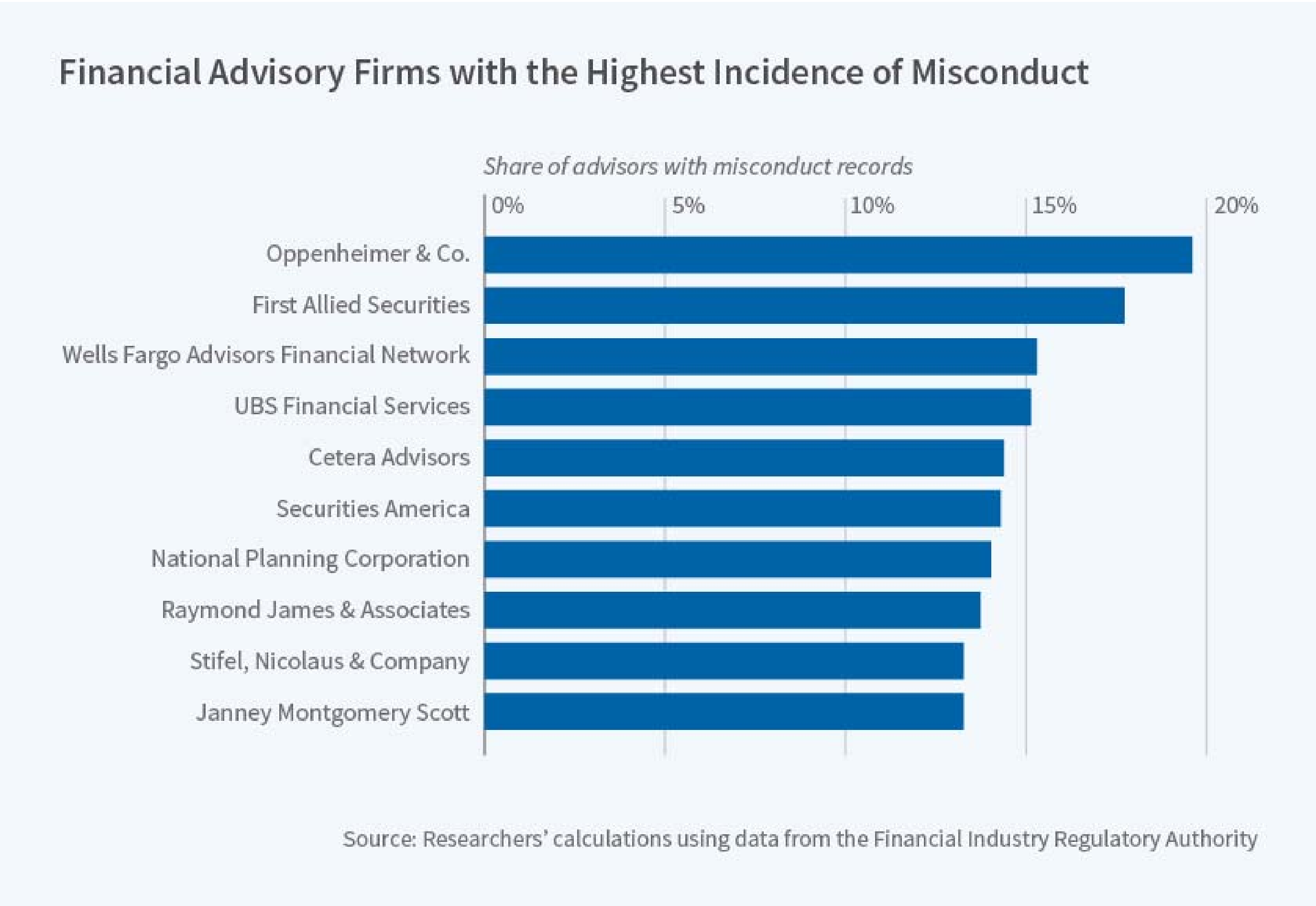
Misconduct definition in study focuses on six categories:

- Customer dispute – settled
- Regulatory – final
- Employment separation after allegations
- Customer dispute – award/judgment
- Criminal – final disposition
- Civil – final disposition

Adviser Misconduct: How Widespread?

- 7% of advisers have misconduct-related disclosure on record
- 25% of advisers with misconduct records are repeat offenders and five times more likely to engage in misconduct
- 44% of advisers who lost jobs after misconduct find employment in industry within one year
- Some firms employ substantially more “bad actors” than other firms

Adviser Misconduct: How Widespread?



Adviser Misconduct: How Widespread?

In previous slide, note the type of firms that employ the most advisers who have engaged in misconduct

They are generally catering to retail investors, **not** institutional clients

[Egan-Matvos-Seru database for "The Market for Financial Adviser Misconduct"]

Adviser Misconduct: How Widespread?

Misconduct more common in wealthy, elderly, and less educated counties.

In other words, go where the money is:

> In certain counties in Florida and California, approximately 1 in 5 advisers have engaged in misconduct in past

Adviser Misconduct: How Widespread?

In Texas, percentage of advisers with misconduct was

7.91%

the middle of U.S. states 2005-2015

Texas counties with highest % of misconduct:

Randall: 12.7%
Cameron: 12.5%
Williamson: 12.08%
Montgomery: 11.72%
El Paso: 11.67%

El Paso: 11.67%
Jefferson: 11.31%
McLennan: 10:23%
Collin: 10.01%
Smith: 9.62%

[Egan-Matvos-Seru database for "The Market for Financial Adviser Misconduct"]

Questions?

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