Financial advisor misconduct and race

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Abstract: We examine differences in misconduct by the race of advisors and the race of their client base. We find that non-white advisors have a lower propensity of misconduct, and that misconduct is generally lower in areas where advisors serve a more racially diverse clientele. The findings are consistent with diversity in the financial services sector improving client outcomes.

Key words: Financial advisors, Race

JEL code: G24 Advisors; J15 Race

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1. Introduction

Despite an increasing trend in the proportion of non-whites in the U.S. population, there remains a persistent underrepresentation of non-whites in the financial services sector. For example, while non-whites represent about 37% of the average county, they represent less than 15% of financial advisors. Given the low representation of minorities in the financial services sector, government, regulatory agencies, and firms have pushed for greater diversity. While greater diversity is generally viewed as positive, a vocal minority have pushed against diversity, equity, and inclusion (DEI) mandates. This paper explores whether a diverse population of financial advisors improves the outcomes of a diverse group of investors. Specifically, we investigate whether the propensity of financial advisor misconduct varies by the race of the advisor, and the population which it serves. We find that non-white advisors have a lower propensity of misconduct, and that misconduct is generally lower in areas where advisors serve a more racially diverse clientele.

To examine this relation, we follow Egan et al. (2019, 2022) to first construct an advisor-year panel of all financial advisors (around 1.2 million) who were registered with the U.S. Financial Industry Regulatory Authority (FINRA) at any time between January 2009 and December 2019. We use *NamePrism*, provided by Ye et al. (2017) to classify an advisor's race/ethnicity using their first and last names. We then match this data set with a county's race composition using data from the US Census and American Community Survey (ACS).

We compare the misconduct propensity of minority financial advisors from the same firm, at the same office location, and at the same point in time and use white financial advisors as the benchmark group. Specifically, we include firm, county, and year fixed effects in the regression to absorb observed and unobserved heterogeneity.

2. Background information

FINRA, established in 2007, is a self-regulatory organization that regulates brokerage firms and advisors in the securities industry. Any entity or individual engaged in securities-related activities within the United States must be registered with FINRA. FINRA was formed through the merger of the National Association of Securities Dealers (NASD) and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange (NYSE). FINRA operates as a nonprofit organization empowered by the U.S. Congress to create and enforce rules that oversee the operations of registered firms and their advisors. Its mandate includes safeguarding investor interests and promoting market transparency.

As part of its commitment to enhancing investor protection, FINRA oversees a complimentary online tool called BrokerCheck (https://brokercheck.finra.org). This platform enables investors to research financial advisors and their respective firms. Within BrokerCheck, investors can search for advisors by name and access detailed reports containing the advisor's identifying information, employment history, passed examinations, professional designations, and disclosure events.

Disclosure events, categorized into 23 types, include customer complaints, arbitration cases, criminal records, personal bankruptcy, civil litigation, and regulatory actions. These disclosures originate from Form U4 filings, mandatory submissions by all financial advisors to maintain FINRA registration. Advisors are obligated under FINRA bylaws to promptly update their Form U4 within 30 days of learning about any disclosure event. Failure to disclose or delayed updates can result in disciplinary actions by FINRA, ranging from suspension to permanent expulsion from registration.

Investors also have the right to file misconduct complaints with FINRA concerning their financial advisors. According to FINRA Rule 4513, customer reported misconduct is defined as "any grievance by a customer or authorized person involving the activities of a member or associated person related to the solicitation or execution of a transaction or the handling of securities or funds." Common types of misconduct include misrepresentation, where material facts are misrepresented or omitted in investment recommendations; unsuitability of recommendations for the investor's circumstances; and unauthorized trading, which involves executing transactions without the client's consent.

Upon receiving a misconduct report, FINRA typically requests additional information and documentation from the advisors and their firms and may proceed with an investigation based on gathered facts. FINRA holds jurisdiction over all registered financial advisors and brokerage firms, and can enforce disciplinary actions based on investigative findings.

To resolve disputes, customers can pursue arbitration or mediation through FINRA with their advisors. Arbitration tends to be more costly and time-consuming compared to mediation. Typically, settlements or awards resulting from these processes amount to a fraction of the original sum sought by investors. Estimates suggest that misconduct settlements cost the financial advisory industry approximately half a billion dollars annually (Egan, Matvos, and Seru, 2019).

3. Data and Summary Statistics
3.1. Data

Our main sample is from the historical Form U4 submitted by financial advisors as part of their registration with FINRA. These filings are electronically archived in BrokerCheck for public access. Basic personal information, history of misconduct, and qualifications of financial advisors are included in these filings. We define misconduct as substantiated customer complaints related to financial misconduct by advisors, following Dimmock, Gerken and Graham (2018) and Law and Zuo (2022). These filings, however, do not disclose the race/ethnicity of financial advisors. We use *NamePrism*, generously provided by Ye et al. (2017) to classify an advisors' race/ethnicity. *NamePrism* estimates the probability that a name belongs to one of 6 races: white, black, Asian, Hispanic, API (Asian and Pacific Islander), AIAN (American Indian and Alaska Native) or 2PRACE (two or more races).[1] In addition to using these probabilities, we also assign advisors to a single race if the probability of that race is at least 85%. Our final sample includes about 1.2 million financial advisors who were registered at any point in time between January 2009 and December 2019.[2]

We also estimate the race composition of each county's population from the U.S. Census (1990, 2000, 2010) and ACS (2015), using the same race definitions from *NamePrism*. We calculate a county's race composition in two ways: using all individuals in a county or using only investors. Investors are defined as those in the top tercile of income in each year. We merge the advisor data to the county-level Census/ACS data based on the county where the advisor's firm is located and the nearest year. For example, we match 2012-year advisor using 2010 census data.

In addition to separately examining an advisor's race and a county's race composition, we also calculate a parsimonious measure that captures the difference between an advisor's estimated race and the race composition of the county where the advisor works. The measure we use is the L1 distance (also known as the taxicab or Manhattan distance), which is defined as:

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[1] Figure 1 shows an example using the name Barack Obama.

[2] FINRA requires financial advisors to report their employment history over the past 10-years, but advisors may choose to report longer than the minimum period. Financial advisors cannot delete the disclosure record.

$$L1\ Dist = |white\ prob - white\ \%| + |black\ prob - black\ \%|$$
$$+ |hispanic\ prob - hispanic\ \%| + |API\ prob - API\ \%|$$
$$+ |AIAN\ prob - AIAN\ \%| + |2PRACE\ prob - 2PRACE\ \%|.$$

Higher values of the distance measure indicate larger differences between the estimated race of the advisor the race composition of the county where the advisor works.

3.2. Summary Statistics

Table 1 reports the summary statistics of the main variables used in our analyses. Approximately 14% of advisor-year observations are for non-white advisors, which is much lower than the 37% composition of non-whites in the average county. The rate of misconduct is 0.85%, which is similar to the 0.71% reported in Law and Zuo (2022) over an earlier sample period from 2007 to 2017.

4. Regression and results
4.1. Advisor race and misconduct

To examine whether misconduct varies by the race of financial advisors, we estimate the following linear probability model:

$$Misconduct_{ijlt} = \beta_1\ Hispanic_{ijlt} + \beta_2 Black_{ijlt} + \beta_3 API_{ijlt} + \beta_4 AIAN_{ijlt} + \beta_5 2PRACE_{ijlt} + \eta_j + \eta_l$$
$$+ \eta_t + \epsilon_{ijlt},$$

where the dependent variable, $Misconduct$, is an indicator variable equal to one if misconduct is reported against advisor i at firm j in county l for year t, while the independent variables are either the probabilities associated with an advisor's race, or indicators for the estimated advisor's race. The white race is the omitted category. Two sets of fixed effects are included in the regression specification. First, we include firm and year fixed effects in our regression specification so that we compare minority advisors with their white colleagues who work in the same firm j and in the same year t. These fixed effects absorb an array of observable and unobservable factors that could affect financial advisor misconduct: variations in firms' tolerance for misconduct, different business models (e.g., retail vs. nonretail) or incentive structures that firms may have and market volatility in different years. Second, we include firm, county and year fixed effects to control for an array of observable and unobservable county characteristics that could affect financial advisor misconduct, such as differences in demographics and labor market or economic conditions in a given county (Law and Zuo 2022).

Table 2 summarizes the results. The coefficient estimates of Hispanic, Black and API are significantly negative. For example, column (4) indicates that Hispanics are 9.2% less likely to commit misconduct as compared with their white colleagues who work in the same firm and county. The table suggests that clients are less likely to be exploited by minority advisors.

4.2. County race and misconduct

To examine whether misconduct varies by the race of the client-base, we estimate the following linear probability model:

$$Misconduct_{ijlt} = \beta1\ Hispanic\ \%_{ijlt} + \beta_2\ Black\ \%_{ijlt} + \beta_3 API\ \%_{ijlt} + \beta_4 AIAN\ \%_{ijlt}$$
$$+ \beta_5 2PRACE\ \%_{ijlt} + \eta_j + \eta_l + \eta_t + \epsilon_{ijlt},$$

where, the dependent variable $Misconduct$ is an indicator variable equal to one if there is a misconduct report against advisor i at advisory firm j in county l for year t, while the independent

variables are the county-level race composition for each year. The white race is the omitted category.

Table 3 reports our results, where column (1) uses the race composition for the entire county population, while column (2) uses the race composition only for investors. Investors are defined as those in the top tercile of income. Differences in the magnitudes and significance of the coefficients across both columns indicate the importance of properly defining the client-base. Focusing only on investors in column (2), the coefficient on *API %* is significantly negative indicating that advisors in counties with a higher proportion of Asians and Pacific Islanders are less likely to commit financial misconduct. Specifically, a one unit increase in API is related to a 1.27% (1.049/0.848) decrease in the propensity of misconduct relative to the average rate of misconduct (0.848%). Table 4 runs the tests separately for financial advisors of different races. The table indicates that the negative relationship between the county's proportion of APIs and misconduct in Table 3 is largely driven by white financial advisors.

4.3. Diversity and misconduct

To examine whether misconduct varies by differences between the race of advisors and their clients, we estimate the following linear probability model:

$$Misconduct_{ijlt} = \beta 1 \, L1 \, Dist_{ijlt} + \eta_j + \eta_l + \eta_t + \epsilon_{ijlt},$$

where the dependent variable $Misconduct$ is an indicator variable equal to one if there is a misconduct report against advisor i at advisory firm j in county l for year t. $L1 \, Dist$ measures the racial distance between a financial advisor and investor's race composition for each county.

Table 5 indicates that the coefficient on the L1 distance measure is significantly negative, suggesting that advisors in counties whose racial composition differs from that of the advisor are less likely to commit misconduct. Specifically, a one unit increase in the L1 distance measure is associated with a 9.67% (0.082/0.848) decrease in misconduct relative to the average rate of misconduct (0.848%).

To examine diversity of which rate is important in explaining financial misconduct, we decompose L1 Norm into different races and estimate the following linear probability model:

$$Misconduct_{ijlt} = \beta_1 \, Hispanic \, diff_{ijlt} + \beta_2 Black \, diff_{ijlt} + \beta_3 API \, diff_{ijlt} + \beta_4 AIAN \, diff_{ijlt} + \eta_j + \eta_l + \eta_t + \epsilon_{ijlt},$$

where the dependent variable $Misconduct$ is an indicator variable equal to one if there is a customer reporting misconduct of advisor i at advisory firm j in county l in year t. *Diff* is defined as the difference between the estimated race of the advisor and the proportion of investors for the same race in the county that the advisor works.

Table 6 confirms that larger differences between the race of the advisor and the race of its client base is associated with lower misconduct. Specifically, the coefficients for Hispanic, Black, and API differences are significantly negative.

5. Conclusion

We examine differences in misconduct by the race of advisors and the race of their client base. We find that non-white advisors have a lower propensity of misconduct, and that misconduct is generally lower in areas where advisors serve a more racially diverse clientele. Taken together, the results present evidence that diversity in the financial services sector can improve client outcomes.

Table 1 Summary Statistics

Advisor race is the single estimated race of an advisor. *County race* is the proportion of a county's population for a given race. *L1 Norm* is the difference between different race possibility and county race composition. *Misconduct* is an indicator variable equal to one if there is misconduct report for an advisor.

	Mean	Std Dev	P50	N
Panel A: Advisor race				
White	0.859	0.348	1	11,783,538
Black	0.001	0.028	0	11,783,538
Hispanic	0.018	0.132	0	11,783,538
AIAN	0.000	0.002	0	11,783,538
API	0.033	0.179	0	11,783,538
2PRACE	0	0	0	11,783,538
Panel B: County race				
White %	0.625	0.184	0.589	11,783,538
Black %	0.137	0.119	0.123	11,783,538
Hispanic %	0.156	0.127	0.136	11,783,538
AIAN %	0.004	0.017	0.002	11,783,538
API %	0.055	0.051	0.041	11,783,538
2PRACE %	0.024	0.016	0.024	11,783,538
Panel C: Other				
L1 Norm	0.721	0.415	0.732	11,783,538
Misconduct %	0.848	9.168	0	11,783,538

Table 2 Financial advisor misconduct on advisor race
This table reports the coefficient estimates of linear probability model regressions. Each observation is at the advisor-year level. The dependent variable is expressed in percentage points. The benchmark group is white financial advisors. *<Race> prob* is the probability of being a specific race based on the first and last name of the financial advisor. *API* indicates Asian and Pacific Islander. *AIAN* indicates American Indian and Alaska Native. *2PRACE* indicates more than two races. *Hispanic, Black, API, and AIAN* are the corresponding single race indicators. *2PRACE* is omitted because lack of sufficient observations. *Misconduct* is an indicator variable equal to one if there is a misconduct report for an advisor. Standard errors are clustered at the advisory firm, county and year level, and t-statistics are reported in parentheses. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% level, respectively, based on a two-tailed test.

Independent variables	Dependent variable			
	Misconduct %	Misconduct %	Misconduct %	Misconduct %
Hispanic prob	-0.150***	-0.175***		
	(-3.195)	(-3.365)		
Black prob	-0.360***	-0.345***		
	(-3.609)	(-3.708)		
API prob	-0.290***	-0.261***		
	(-5.052)	(-7.661)		
AIAN prob	-0.345*	-0.301		
	(-0.475)	(-0.399)		
2PRACE prob	4.103	3.670		
	(1.585)	(1.513)		
Hispanic			-0.075*	-0.092*
			(-1.785)	(-1.787)
Black			-0.403**	-0.359***
			(-3.263)	(-3.056)
API			-0.248***	-0.217***
			(-4.563)	(-7.104)
AIAN			1.560	1.635
			(0.973)	(0.966)
County FE		YES		YES
Firm FE	YES	YES	YES	YES
Year FE	YES	YES	YES	YES
N	11,772,858	11,770,132	11,772,859	11,770,133
R squared	0.010	0.011	0.010	0.010

Table 3 Financial advisor misconduct on county race composition

This table reports the coefficient estimates of linear probability model regressions. Each observation is at the advisor-year level. The values of dependent variables are expressed in percentage points. Column (1) reports the results for the race composition of all individuals for each county, while column (2) reports the results for the race composition of investors (top tercile of income) for each county. *Hispanic %* is the county level composition of Hispanic people. *Black %* is the county level composition of black people. *API %* is the county level composition of Asian and Pacific islander. *AIAN %* is the county level composition of American Indian and Alaska Native. *2PRACE %* is the county level composition of individuals with more than two races. *Misconduct* is an indicator variable equal to one if there is a misconduct report for an advisor. Standard errors are clustered at the advisory firm, county and year level, and t-statistics are reported in parentheses. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% level, respectively, based on a two-tailed test.

	All	Investors
	Misconduct %	*Misconduct %*
Hispanic %	0.577***	0.027
	(2.959)	(0.312)
Black %	-0.416***	-0.152
	(-2.736)	(-1.436)
API %	-1.962***	-1.049**
	(5.114)	(-2.471)
AIAN %	2.256	0.292
	(1.254)	(0.908)
2PRACE %	1.944	0.137
	(1.360)	(0.169)
Firm FE	YES	YES
Year FE	YES	YES
N	11,772,858	11,772,858
R squared	0.011	0.010

Table 4 Financial advisor misconduct by race

This table reports the coefficient estimates of linear probability model regressions by race of the advisors. Each observation is at the advisor-year level. The dependent variables are expressed in percentage points. *White %* is the county level composition of white investors. *Hispanic %* is the county level composition of Hispanic investors. *Black %* is the county level composition of Black investors. *API %* is the county level composition of Asian and Pacific Islander investors. *AIAN %* is the county level composition of American Indian and Alaska Native investors. *2PRACE%* (more than 2 races) is omitted because of collinearity. AIAN advisors are omitted because of a lack of observations. *Misconduct* is an indicator variable equal to one if there is a misconduct report for an advisor. Standard errors are clustered at the advisory firm, and year level, and t-statistics are reported in parentheses. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% level, respectively, based on a two-tailed test.

	White	Hispanic	Black	API	Unclassified
	Misconduct%	*Misconduct%*	*Misconduct%*	*Misconduct%*	*Misconduct%*
Hispanic %	0.055	0.216	-0.247	0.191	0.182
	(0.611)	(0.983)	(-0.420)	(1.427)	(1.584)
Black %	-0.134	0.618*	0.313	-0.393	-0.332**
	(-1.301)	(1.735)	(0.744)	(-1.355)	(-2.197)
API %	-1.043**	-0.438	1.330	-0.129	-0.897*
	(-2.324)	(-0.567)	(1.011)	(-0.356)	(-1.962)
AIAN %	0.234	0.595	3.107	-0.096	0.741
	(0.714)	(0.553)	(0.088)	(-0.067)	(1.309)
2PRACE %	-0.815	4.327	-8.949*	0.233	2.625
	(-0.942)	(1.106)	(-1.178)	(0.161)	(1.934)
Firm FE	YES	YES	YES	YES	YES
Year FE	YES	YES	YES	YES	YES
N	10,110,728	204,527	8,942	386,287	1,048,769
R squared	0.010	0.020	0.072	0.017	0.014

Table 5 Financial advisor misconduct on L1 Norm

This table reports the coefficient estimates of linear probability model regressions. Each observation is at the advisor-year level. The values of dependent variables are expressed in percentage points. *L1 Dist* is the L1 distance between the race probability of the advisor and the county race composition. *Complaint* is an indicator variable equal to one if there is a misconduct report against an advisor. Economic Magnitude divides the estimated coefficient by the mean of the dependent variable. Standard errors are clustered at the fixed effects level, and t-statistics are reported in parentheses. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% level, respectively, based on a two-tailed test.

Independent variables	Dependent variable	
	Misconduct %	Misconduct %
L1 dist	-0.110**	-0.082***
	(-2.700)	(-3.404)
Economic Magnitude	12.97%	9.67%
County FE		YES
Firm FE	YES	YES
Year FE	YES	YES
N	11,772,862	11,770,136
R squared	0.010	0.011

## Table 6 Financial advisor misconduct on race decomposition

This table reports the coefficient estimates of linear probability model regressions. Each observation is at the advisor-year level. The values of dependent variables are expressed in percentage points. The independent variables indicate the difference between the probability of a financial advisor's race and county level race composition of investors. *White diff* is the omitted category. Standard errors are clustered at the fixed effects level, and t-statistics are reported in parentheses. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% level, respectively, based on a two-tailed test.

	Misconduct %	Misconduct %
Hispanic diff	-0.092**	-0.168***
	(-2.235)	(-3.562)
Black diff	-0.016	-0.402***
	(-0.231)	(-4.139)
API diff	-0.229***	-0.242***
	(-5.385)	(-7.098)
AIAN diff	-0.714*	-0.282
	(-1.767)	(-0.665)
2PRACE diff	1.465***	-0.141
	(2.729)	(-0.132)
County FE		YES
Firm FE	YES	YES
Year FE	YES	YES
N	11,772,858	11,770,132
R squared	0.010	0.011

Figure

Figure 1 *NamePrism* possibility of race

Ethnicity	Probability
Black	0.7079
White	0.2886
API	0.0021
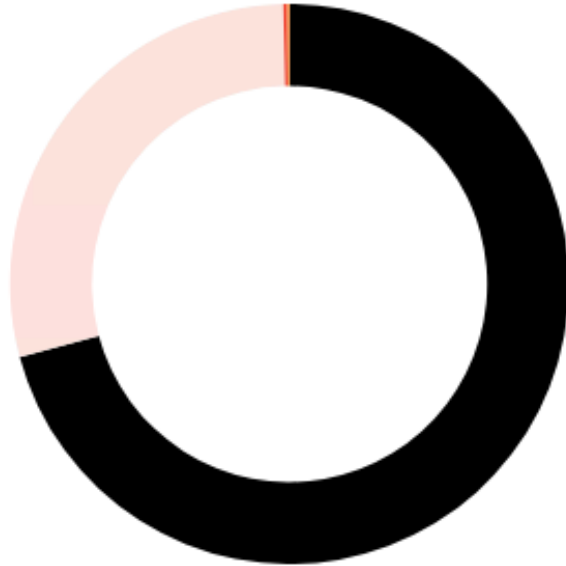
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Appendix

Variables	Mean	Std Dev	P50	N
Advisor race prob				
White prob	0.881	0.238	0.966	11,783,538
Black prob	0.034	0.064	0.011	11,783,538
Hispanic prob	0.038	0.154	0.003	11,783,538
AIAN prob	0.001	0.005	0.001	11,783,538
API prob	0.045	0.185	0.002	11,783,538
2PRACE prob	0.001	0.002	0.000	11,783,538