

May 11, 2016

Richard G. Ketchum
Chairman and Chief Executive Officer
Financial Industry Regulatory Authority
1735 K Street
Washington DC, 20006

Dear Chairman Ketchum:

A recent study analyzing records from FINRA's own database found high rates of misconduct among the financial advisers under FINRA's supervision. Although the vast majority of professionals in the industry conduct themselves ethically, patterns of misconduct highlighted in the study are concerning. While FINRA states that it "works every day to ensure that . . . every investor receives the basic protections they deserve,"¹ this study demonstrates that FINRA is not doing nearly enough to fulfill its investor protection mission. We write today to ask what specific steps FINRA will take to address the pervasive misconduct among its financial advisers and to protect families looking to invest their hard-earned savings.

Adviser Misconduct Exists at Unacceptably High Levels

A February 2016 National Bureau of Economic Research (NBER) working paper, analyzing data from FINRA's BrokerCheck database, found that financial adviser misconduct is "broader than a few heavily publicized scandals."² These experts found that "one in thirteen financial advisers have a misconduct-related disclosure on their record."³ Advisers with misconduct-related disclosures on their record include, for example, individuals who have faced criminal charges for offenses such as bribery, forgery, extortion, or fraud; those who were subject to a final, formal proceeding by the SEC or a state securities agency for a violation of investment-related regulations; and advisers who were fired or permitted to resign after being accused of fraud or violating investment statutes.⁴

¹ FINRA, "About FINRA" (online at <http://www.finra.org/about>).

² Mark Egan, Gregor Matvos, and Amit Seru, "The Market for Financial Adviser Misconduct," National Bureau of Economic Research Working Paper 22050 (February 26, 2016) (online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2739170), p. 2.

³ Id. at 2-3.

⁴ Id. at 53-55.

This misconduct persists, in part, because of ineffective sanctions for advisers. According to the study, only about half of the advisers who committed misconduct lost their job, and 44% of those obtained a job at another advisory firm within a year.⁵ Perhaps more disturbing, about one-third of all advisers with a misconduct record are “repeat offenders” – and these past offenders are “five times more likely to engage in misconduct than the average adviser.”⁶

This behavior exposes investors to real risk. The researchers found that some firms appear to “specialize” in misconduct by hiring advisers with misconduct records and by failing to fire advisers who commit misconduct.⁷ In addition, they found that those firms tend to “cater to unsophisticated customers,” particularly the elderly and those with less education, meaning that the most vulnerable consumers are more heavily exposed to firms that employ disreputable individuals.⁸ At firms where advisers with misconduct disclosures are most heavily represented, more than one in five advisers have a record.⁹

FINRA Has a Responsibility to Address Misconduct

FINRA is the primary regulator and gatekeeper of financial advisers in this country. Broker-dealers must be FINRA members in order to conduct securities transactions and do business with investors. FINRA also writes and enforces the rules that govern the activities of these firms and the brokers within them, ensuring that they remain in compliance.

In short, FINRA has a paramount responsibility to protect investors by addressing misconduct by financial advisers. The risks to investors posed by advisers with a disciplinary history are disturbing – but they are not unpredictable. In fact, the NBER analysis confirms past research by FINRA’s own economists that also shows brokers with specific types of disciplinary and employment history have a significantly higher propensity for investor harm.¹⁰ FINRA is responsible for addressing the risks posed by these brokers and firms so that investors can obtain the scrupulous, high-quality financial advice they deserve.

Summary and Questions

Shortly after the NBER working paper was released, Chairman Ketchum testified before the Senate Committee on Banking, Housing, and Urban Affairs that he found the study’s results “dismaying.”¹¹ He also stated that FINRA took into account the disciplinary history of advisers

⁵ Id. at 15.

⁶ Id. at 3.

⁷ Id. at 27.

⁸ Id. at 1.

⁹ Id. at 37; Craig McCann, Chuan Qin, and Mike Yan, “How Widespread and Predictable Is Stock Broker Misconduct?” Securities Litigation and Consulting Group (Apr. 21, 2016) (online at <http://slcg.com/securities-research.php?cid&i=111>), p. 32.

¹⁰ Hammad Quereshi and Jonathan Sokobin, “Do Investors Have Valuable Information About Brokers?” FINRA Office of the Chief Economist Working Paper (August 2015) (online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2652535).

¹¹ Senate Committee on Banking, Housing, and Urban Affairs Subcommittee on Securities, Insurance, and Investment, “Regulatory Reforms to Improve Market Structure” (Mar. 3, 2016) (online at <http://www.banking.senate.gov/public/index.cfm/hearings?ID=DA564AFA-2883-4B1A-B646-901285062E90>).

and the firms who hired them, saying “that's exactly the risk we look at with respect to our exams and enforcement investigations.”¹² And just last week FINRA announced an expansion of the BrokerCheck database to include “new disclosures about where brokers accused of misconduct concentrate.”¹³ Yet the evidence clearly shows that FINRA’s efforts to date have not been enough to address the incidence of misconduct among financial advisers. Each day that FINRA fails to take stronger action is another day that working families will be exposed to an unacceptably high risk of financial adviser misconduct.

Accordingly, we ask that you provide us with the following information:

1. What specific steps is FINRA taking to address unacceptable levels of adviser misconduct across the entire financial advisory industry?
2. What specific steps is FINRA taking to address the problem of high rates of recidivism among advisers with a history of disciplinary misconduct?
3. What specific steps is FINRA taking, beyond increased disclosures in BrokerCheck, to tackle the problem of firms that employ a large share of advisers with a history of misconduct-related disclosures on their records?

Please respond to this request no later than June 15, 2016. Thank you for your assistance in providing this information. If you have any questions related to this request, please contact Brian Cohen or Bharat Ramamurti in the office of Senator Elizabeth Warren at (202) 224-4543 or Jonny Hiler in the office of Senator Tom Cotton at (202) 224-2353.

Sincerely,



Cc:
Mary Jo White
Chair
Securities and Exchange Commission

¹² Id.

¹³ Dave Michaels, “Brokerages with Checkered Past to Face New Disclosure Focus, Finra CEO Says,” *Wall Street Journal* (May 9, 2016) (online at <http://www.wsj.com/articles/brokerages-with-checkered-past-to-face-new-disclosure-focus-finra-ceo-says-1462308550>).