

IS FRAUD CONTAGIOUS? CAREER NETWORKS AND FRAUD BY FINANCIAL ADVISORS

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EFA Summer 2015

Discussion Overview

Punchline: Fraud by financial advisors spills over to other financial advisors through office contagion

- Fits into a new literature about how bad financial advisors are
- Very important result for thinking about regulations and associations
 - The “Legal Bar Association”, e.g., self regulates lawyers
 - The contagion documented in this paper implies a real need to consider steps by advisors to improve who and what they do.
- In the spirit of my interpretation of this important, my first comment is a wish list that the authors would cast a wider net

Outline

I. Comments on Big Picture

II. Comments on Empirics

Big Picture

- I want to cast a big picture of “why we care” about this research
 - Arguing for: Stronger pitch on the “so what?”
 - Current: a micro finding that fraud is contagious
 - Important? Sure. Put these guys in jail or at least away from people’s money
 - Wanted: macro implications

Sah (1991, JPE)

"In this analysis, individuals' perceptions (concerning their probabilities of punishment) and choices are determined endogenously.... The resulting dynamic relationships are then studied to examine how criminality might evolve over time, why crime participation rates might differ among societal groups even when they face similar economic fundamentals, and how the features of the economy might affect these rates."

Glaeser, Sacerdote, Scheinkman (QJE 1996)

- The high variance of crime rates across time and space is one of the oldest puzzles in the social sciences; this variance appears too high to be explained by changes in the exogenous costs and benefits of crime. We present a model where social interactions create enough covariance across individuals to explain the high cross-city variance of crime rates.

Big Picture

- I want the answer to the “so what?” question of how big the implications could be
 - Also has implications for enforcement and cultural norms /tolerance
- 1. How many bad apples do you need to create a culture of fraud?
- 2. Are their already enough bad apples financial advisors such that all of the industry is doomed to be corrupt?
- 3. Is the variance of existing bad apples across states (e.g., Parsons Sulaeman Titman) reflective of this contagion
 - Could also think at country level
- To me, the big picture is the importance of fraud in the macroeconomy as a first-order hindrance to household well being. It is fine to uncover contagion, but I want implications pitched in the paper.

Literature on Financial Advisors' Advice (incomplete)

- Generally advice makes those that seek (or opt-into) advice worse off by:
 - **Taking on more risk**
 - Chalmers Reuters 2011; Mullainathan Noeth Schoar 2012
 - **Going into high-cost investments (that pay the advisor)**
 - Mullainathan Noeth Schoar 2012
 - **Or just being dumber (or at least not smarter)**
 - Bergstresser Chalmers Tufano 2007; Chalmers Reuters 2011
- **But take-up of advisors is weak or with those that need it the least**
 - Bhattacharya, Hackethal, Kaesler, Loos, Meyer 2011
 - Hoechle, Ruenzi, Schaub, Schmid 2015

Big Picture 2

- Does the prior literature find such dismal performance of financial advice on average because of fraud?
 - Probably too few frauds for this to be the case
- Or because of perception of “these are crooks” scaring away those that need advice most?

II. Comments on Empirics

1) Unobservables

2) Magnitudes

Empirics: Growth and Unobservability

Fraud rate:	Pre-Merger Coworker Fraud = "No"	Pre-Merger Coworker Fraud= "Yes"	
Pre	0.71%	2.04%	WtAve: 1.14%
Post	1.44%	2.54%	WtAve: 1.80%

- Stats: Focus on the **No Coworker Fraud** column for a moment
 - Pre, firms have fraud rate of 0.71% generally
 - Post, firms have fraud rate of 1.44%. Fraud rate doubles. Why?
 - **Merger Tension?**
 - **Detection rate?**

Empirics: Growth and Unobservability

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- Furthermore
 - Why isn't the ongoing growth as large for the blue column?
 - Worried about identification picking up heterogeneities?

Empirics: Growth and Unobservability

- Story 1: **Merger tension** takes toll on all offices. Stress? Attrition?
 - Do these differ when you are merging with bad local management
 - Do the good guys leave?
 - What about when merging with good management
 - Are the bad advisors forced out?
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- Under this story, the main result could be due to environment of bad management becoming more important post-merger and not contagion directly (subtle difference)
 - Authors try to test by interacting with supervisors with history of fraud, but this is not the same as just management skill

Empirics: Growth and Unobservability

- Story 2: **Detection rate**
- Idea: Revealed frauds are just tip of iceberg
 - Many fraud never caught
 - Dyck, Morse, Zingales, 2014: $\frac{1}{4}$ (to $\frac{1}{2}$) of corporate fraud are caught.
 - Identification uses a “shake-up” event of AA demise
 - Idea: when firms get forced new auditor, the new auditor has the incentive to clean shop
- Issue here: What if a merger shakes up revelation of ongoing fraud
 - This seems likely
 - Then, a group of people who are already committing fraud will be revealed in both the target and the acquirer
 - Furthermore, in a place acquiring former advisors with a history of fraud, this shake up may be more intense
 - Either of these facts could explain result.

Empirics: Magnitude

- The logit marginal effect is (I think) about 0.005
 - (The paper says fraud increases by 38%)
 - This decreases in some of robustness tests
 - I understand these are a lot of people but I really would like to know the magnitude in people...
 - About 300-500 cases over the period 1999-2011 (25-40 cases/year)
- Point:
 1. Numbers small enough such that I'd like to know something about these cases
 2. Returning to macro point... what is the magnitude implication at some broader level
 - Is this purely a micro study?