Misconduct Synergies

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Do corporate control transactions discipline the labor force?

- There is a large empirical finance literature documenting gains to M&A
  - These papers examine announcement period returns, post-takeover stock returns, and changes in profitability (Betton, Eckbo, Thorborn (2008)).
  - Mixed evidence, and limited observability of mechanisms

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Can M&A improve rank-and-file employee behavior?

- The investment advisory industry is a useful laboratory
  - Registration and licensing requires reporting and public dissemination of disclosure data at the individual advisor level

7% of brokers, employed between 2004 to 2019, have at least one disclosure

10/22/2012	Regulatory	Final

Initiated By	NEW JERSEY BUREAU OF SECURITIES
Allegations	SAVIANO ENGAGED IN DISHONEST OR UNETHICAL BUSINESS PRACTICE IN THE SECURITIES BUSINESS BY BORROWING MONEY FROM HIS CLIENTS. SAVIANO ENGAGED IN DISHONEST OR UNETHICAL BUSINESS PRACTICE IN THE SECURITIES BUSINESS BY VIOLATING FINRA RULE 3240. SAVIANO ENGAGED IN A DISHONEST AND UNETHICAL BUSINESS PRACTICE IN THE SECURITIES BUSINESS BY FAILING TO DISCLOSE TAX LIENS AND CIVIL JUDGMENTS. SAVIANO MADE FALSE OR MISLEADING FILINGS WITH THE BUREAU.
Resolution	Order
Sanctions	Civil and Administrative Penalty(ies)/Fine(s)
Amount	$20,000.00

7% of brokers, employed between 2004 to 2019, have at least one disclosure

11/12/2012	Customer Dispute	Settled
Allegations	CLIENTS ALLEGE THAT THE DIRECT INVESTMENTS PURCHASED IN MAY 2012 WERE NOT SUITABLE. CLIENTS ALSO EXPRESSED CONCERN OVER THE TAX LIABILITY INCURRED WHEN THE VARIABLE ANNUITY WAS LIQUIDATED TO PURCHASE ONE OF THE DIRECT INVESTMENTS.	
Settlement Amount	$45,000.00	

We know that misconduct is costly and contagious

- Egan, Matvos, and Seru (2019) document widespread misconduct in the advisory industry
    - One in 13 financial advisors has a misconduct disclosure. These records are costly: $550,000 (mean) $40,000 median settlement
    - One-third of advisers with misconduct are repeat offenders

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  - One-third of advisers with misconduct are repeat offenders
- Dimmock, Gerken, and Graham (2018) document spillovers in misconduct across brokers
  - When exposed to coworker with misconduct record, an employee is more likely to commit misconduct in the next three years. No evidence of spillovers from well-behaved advisors.
  - Interpretation: Fraud is contagious

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- Gurun, Stoffman, and Yonker (2018) document that residents exposed to fraud withdrew assets from investment advisers

Theory has conflicting empirical predictions on who buys whom

- **Market Discipline Hypothesis**: Better behaved firms will buy poorly performing firms. “The potential return from the successful takeover and revitalization of a poorly run company can be enormous” (Manne (1965))
  - Q-theory of mergers (Jovanovic and Rosseau (2002): High MTB firms should buy the lowest)
  - Empirical support: Targets’ asset valuations are generally lower than acquirers’

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- **Complements Hypothesis**: “Like-buys-like” (Rhodes-Kropf and Robinson (2008))
  - Model is based on asset complementarity and search frictions
  - Empirical support: bidders and targets have similar market-to-book ratios
  - Comparing hypothetical to actual mergers, evidence of assortative matching on MTB

Empirical predictions for M&A and employee misconduct

- **Market Discipline Hypothesis**
  1. High misconduct firms are more likely to be targets and low misconduct firms are more likely to be acquirers
  2. Low-misconduct acquirers buy high-misconduct targets
  3. Post-merger reductions in misconduct, if any, are driven by changes related to target employees

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- **Complements Hypothesis**:
  1. No predictions on the relationship between misconduct and the likelihood of being a target or an acquirer
  2. Target and acquirers match according to levels of employee misconduct
  3. Post-merger reductions in misconduct, if any, driven by changes related to target employees, acquirer employees, or both

Data

We have 419 mergers in our sample, from 2004 to 2020

- **Advisory Firm and Individual Adviser Data**
  - All Form ADV filings since 2001: Business lines, types of clients, number of employees, AUM
- **Mergers**
  - **Pitchbook**: Financial services sector
  - **SDC**: Investment& Commodities Firms, Dealers, Exchanges sector
  - **Investment News**: Articles announcing mergers, confirmed by Factiva and company website searches
  - **ADV-W (FOIA request)**: Reason for withdrawal is merger-related. Use post-closure employment records and news searches to identify acquirers
- **Filters** : Target and acquirer are U.S.-based investment advisers

“EMS” is sum of 6 less ambiguous disclosures

Employee Other Disclosures (All)		
EMS Disclosures (Employee Misconduct (EMS))	**Other Disclosures**	
Customer Dispute Settled	Financial final	Civil Pending
Employment Separations after Allegations	Customer Dispute denied	Customer Dispute final
Regulatory Final	Judgement/Lien	Customer Dispute dismissed
Criminal Final Disposition	Customer dispute closed no action	Civil bond
Customer Dispute Award/Judgement	Financial pending	Regulatory on appeal
Civil Final	Customer dispute withdrawn	Criminal on appeal
	Criminal pending investigation	Civil on appeal
	Regulatory pending	

Acquirers tend to have higher employee misconduct

	Target (N = 419)		Acquirer (N = 419)		Tests	
	Mean	Std. Dev.	Mean	Std. Dev.	Diff	T-stat
Employee disclosures (All)	1.55	7.77	2.15	5.01	0.09	1.33
Employee misconduct (EMS)	0.73	5.26	0.96	3.42	0.05	0.75
Disclosure growth (All)	0.31	1.77	0.75	1.95	0.23	3.37***
Misconduct growth (EMS)	0.12	0.75	0.30	1.09	0.18	2.66***
# Employees	74.26	485.70	544.54	2507.61	0.26	3.77***
AUM ($ Billions)	3.34	26.24	24.49	63.85	0.43	6.27***

Is misconduct value-relevant in the financial advisory industry?

Is misconduct associated with value-relevant variables?

$$
\begin{aligned}
Outcome_{i(t+1)} = \quad & \beta_1 \text{Misconduct}_{it} + \beta_2 \text{Retail Clients}_{it} \\
& + \beta_3 \text{Ln(Firm Age)}_{it} + \lambda_j + \eta_t + \epsilon_{it}.
\end{aligned}
$$

Outcome:

1. $\text{Ln}(\text{AUM}_{i,t+1})$
2. $\Delta\text{AUM}_{i,t+1})$
3. $\text{Failed}_{i,t+1}$

Recent misconduct is negatively related to year-ahead level of AUM

	Ln(AUM)$_{t+1}$			
	(1)	(2)	(3)	(4)
Employee disclosures (All)	-0.083***	-0.065***		
	(0.009)	(0.009)		
Employee misconduct (EMS)			-0.073***	-0.052***
			(0.010)	(0.008)
CONTROLS?	NO	YES	NO	YES

Δ Recent misconduct is negatively related to year-ahead Δ AUM

	ΔAUM$_{t+1}$			
	(1)	(2)	(3)	(4)
Δ Employee disclosures (All)$_t$	-0.255***	-0.465***		
	(0.083)	(0.090)		
Δ Employee misconduct (EMS)$_t$			-0.276***	-0.407***
			(0.085)	(0.094)
CONTROLS?	NO	YES	NO	YES

S.D. $\Uparrow$ Recent misconduct associated with 5.1% $\Uparrow$ future closures

	$\mathbb{1}$**(Failed)**$_{t+1..}$			
	(1)	(2)	(3)	(4)
Employee disclosures (All)	0.096^{***}	0.067^{**}		
	(0.031)	(0.030)		
Employee misconduct (EMS)			0.077^{**}	0.049^{*}
			(0.030)	(0.029)
CONTROLS?	NO	YES	NO	YES

Is misconduct related to the likelihood of being a target or an acquirer?

Misconduct is negatively related to being a target

	$\mathbb{1}$**(Target)** $\times$ 100			
	(1)	(2)	(3)	(4)
Employee disclosures (All)	-0.057***	-0.041***		
	(0.010)	(0.009)		
Employee misconduct (EMS)			-0.050***	-0.035***
			(0.009)	(0.009)
CONTROLS?	NO	YES	NO	YES

Misconduct is also negatively related to being an acquirer

	$\mathbb{1}$**(Acquirer)** $\times$ 100			
	(1)	(2)	(3)	(4)
Employee disclosures (All)	-0.026***	-0.017**		
	(0.007)	(0.007)		
Employee misconduct (Egan)			-0.024***	-0.008
			(0.006)	(0.006)
CONTROLS?	NO	YES	NO	YES

Association between misconduct and I(target) is inconsistent with market discipline

- The findings that targets have lower-than-average levels of recent misconduct and that those with misconduct are less likely to be acquired is inconsistent with the Market Discipline hypothesis

- Evidence seems to point towards potential complementarities (matching on misconduct)

- To test for assortative matching, we create counterfactual mergers that pair every target will all potential acquirers (those that actually acquired an asset management firm in year t) in the merger year

Is there matching on employee-misconduct in M&A?

Counterfactual pairs for two sample mergers in 2015

Target	**Acquirer**
Halsey	Washington
Enrichment	Pinnacle

Counterfactual pairs for two sample mergers in 2015

Target	Acquirer
Halsey	Washington
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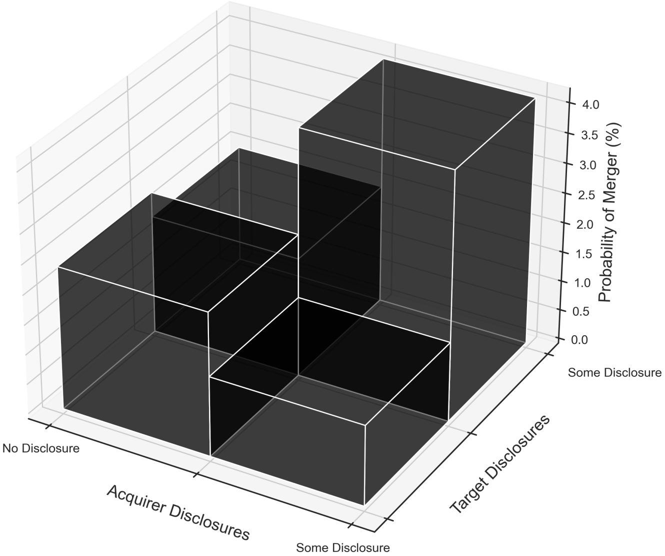
Target	Acquirer	I(Merger)	I(Disc T.)	I(Disc Ac.)
Halsey	Washington	1	1	0
Halsey	Pinnacle	0	1	1
Enrichment	Washington	1	0	0
Enrichment	Pinnacle	0	0	1

Evidence is consistent with matching on misconduct



Here is how we test whether there is matching on misconduct

$$
\begin{aligned}
\mathbb{1}(\textbf{Merged})_{i(t+1)} = \quad & \beta_1 |\text{Disclosure Acq} - \text{Disclosure Tar}|_{it} \\
& + \beta_2 \text{Retail clients}_{it} \\
& + \beta_3 |\text{Ln(AUM Acq)} - \text{Ln(AUM Tar)}|_{it} \\
& + \beta_4 |\text{Ln(Age Acq)} - \text{Ln(Age Tar)}|_{it} \\
& + \beta_5 |\text{Ln(Emp Acq)} - \text{Ln(Emp Tar)}|_{it} \\
& + \beta_6 \text{Same state} + \lambda_i + \eta_t + \epsilon_{it}.
\end{aligned}
$$

Evidence is consistent with matching on employee misconduct

	$\mathbb{1}$(**Merged**) $\times$ 100			
	(1)	(2)	(3)	(4)
$\lvert$Misconduct(Acq $-$ Tar (All))$\rvert$	-0.382***	-0.274***		
	(0.080)	(0.087)		
$\lvert$Misconduct(Acq $-$ Tar (Egan)$\rvert$			-0.312***	-0.239***
			(0.077)	(0.084)
CONTROLS?	NO	YES	NO	YES

Does misconduct drop following mergers? (Misconduct Synergies)

We combine disclosures pre-merger as follows:

Target	Acquirer
Halsey	Washington

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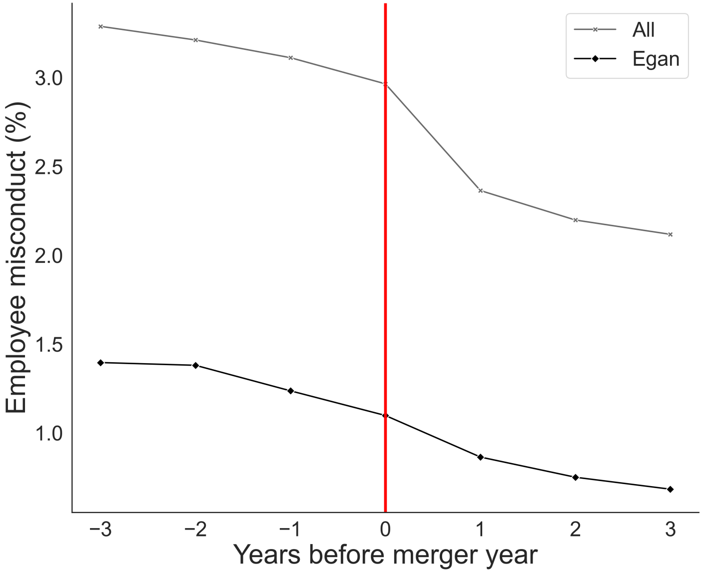
Target	Acquirer
Halsey	Washington

Target	Acquirer	Year	Disc T	Disc Acq	Disc C
Halsey	Washington	2012	1	2	1.5
Halsey	Washington	2013	0	1	0.5
Halsey	Washington	2014	0	1	0.5
Halsey	Washington	2015	1	1	1
Halsey	Washington	2016		0.5	0.5
Halsey	Washington	2017		0.5	0.5
Halsey	Washington	2018		0.5	0.5

Misconduct falls by between 25 and 34 percent following the merger



The level and growth in Misconduct fall following the merger

	Pre Merger		Post Merger		Tests	
	Mean	Std. Dev.	Mean	Std. Dev.	Diff	T-stat
Employee disclosures (All)	2.09	3.05	1.56	2.69	-0.18	-2.56**
Employee misconduct (EMS)	0.88	1.63	0.58	1.20	-0.21	-2.95***
Disclosure growth (All)	0.67	1.09	0.47	0.98	-0.19	-2.62***
Misconduct growth (EMS)	0.28	0.54	0.16	0.40	-0.24	-3.39***
# Employees	529.18	2070.82	571.90	2090.91	0.02	0.29

Why does misconduct fall following the merger?

Test of relationship between misconduct and post-merger separation?

$$
\begin{aligned}
\mathbb{1}(\textbf{Separation})_{i(t+1)} = \quad & \beta_1 \text{Misconduct} \times \text{Post}_{it} \\
& + \beta_2 \text{Misconduct} \\
& + \beta_3 \text{Experience}_{it} \\
& + \beta_4 \text{\# Qualifications}_{it} \\
& + \lambda_{ft} + \epsilon_{it}.
\end{aligned}
$$

- i is an advisor working either for the target or acquirer in the five years before the merger
- λ_{ft} is a firm by year fixed-effect

Misconduct is more sensitive to separations following the merger

	$\mathbb{1}(\textbf{Separation})_{t+1}$			
	(1)	(2)	(3)	(4)
Employee disclosures (All) $\times$ Post	1.079^{**}	1.101^{**}		
	(0.481)	(0.489)		
Employee misconduct (EMS) $\times$ Post			1.483^{***}	1.526^{***}
			(0.384)	(0.402)
Employee disclosures (All)	0.222	0.372		
	(0.343)	(0.348)		
Employee misconduct (EMS)			0.250	0.362
			(0.361)	(0.365)
CONTROLS?	NO	YES	NO	YES

We calculate separation sensitivity separately for each acquirer

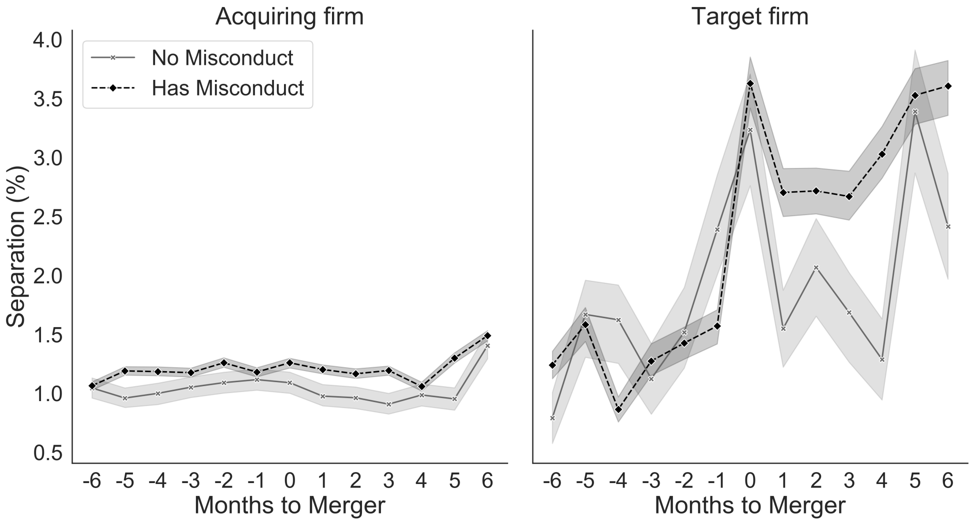
$$\mathbb{1}(\textbf{Separation})_{ia(t+1)} = \beta_1 \text{Misconduct}_{iat} + \eta_t + \epsilon_{iat}.$$

For each acquirer (a), we calculate β_1 using five years of data before the merger.

Misconduct is more sensitive to separations following the merger

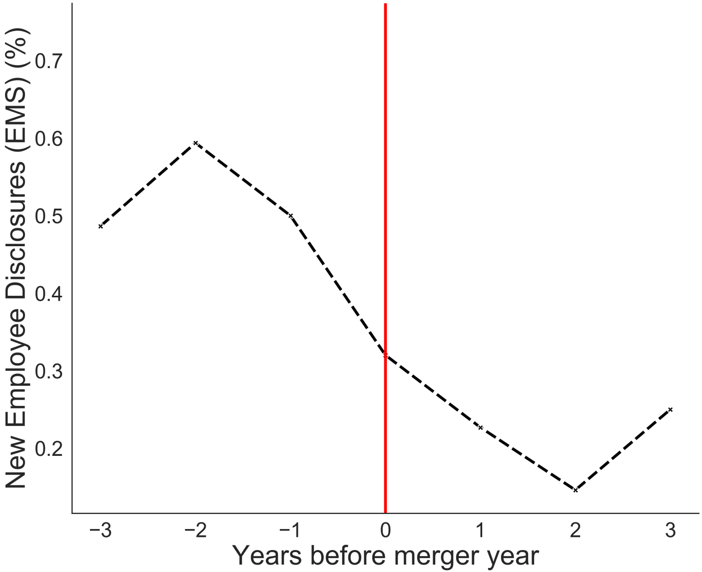
	$\mathbb{1}$(Separation)$_{t+1}$			
	(1)	(2)	(3)	(4)
Employees disclosures (All) $\times$ Post $\times$ HSD	2.136***	2.132***		
	(0.600)	(0.589)		
Employees misconduct (EMS) $\times$ Post $\times$ HSD			1.948***	1.960***
			(0.684)	(0.673)
INTERACTIONS TERMS?	YES	YES	YES	YES
CONTROLS?	NO	YES	NO	YES

Target-firm misconduct more related to separation following M&A



How much of the drop in misconduct is separations?

The drop in misconduct following mergers is driven by separations



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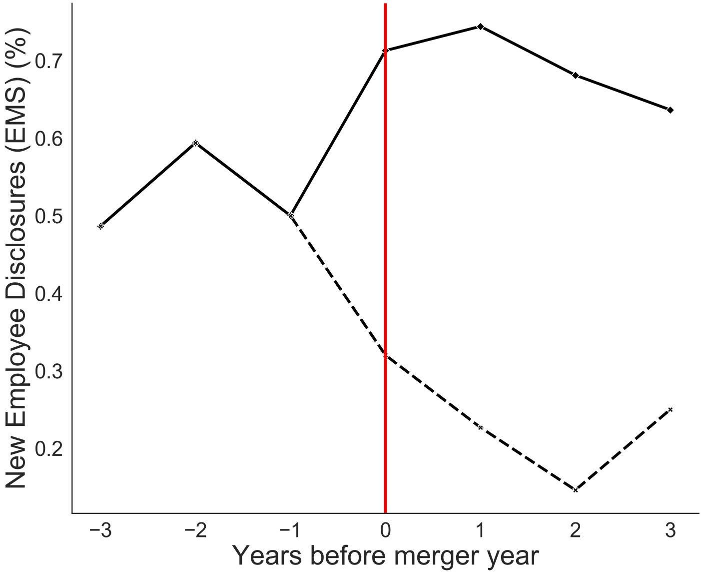

Conclusion: Corporate control transactions discipline the labor force

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  - Yes: Employee misconduct declines by 25 to 34 percent following merger events
  - Driven by separations, especially by acquiring firms that are sensitive to employees disclosures
  - Employees of targets have better misconduct records than acquirers; however, the sensitivity of separation to misconduct increases following mergers (suggesting improved disciplinary mechanisms)

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- ## Can M&A improve rank-and-file employee behavior?
    - Yes: Employee misconduct declines by 25 to 34 percent following merger events
    - Driven by separations, especially by acquiring firms that are sensitive to employees disclosures
    - Employees of targets have better misconduct records than acquirers; however, the sensitivity of separation to misconduct increases following mergers (suggesting improved disciplinary mechanisms)
- Contrary to the market discipline hypothesis, both targets and acquirers have better-than-average misconduct records and appear to sort on misconduct, consistent with complements hypothesis (Rhodes-Kropf and Robinson (2008))
- M&A can be disciplinary for employees more even in a world in which “like buys like.”

Thanks for your attention!