

## Do Investors Have Valuable Information About Brokers?<sup>1</sup>

### Background

BrokerCheck<sup>®</sup> is an online tool provided by the Financial Industry Regulatory Authority (FINRA) to help investors make informed choices about the brokers and securities brokerage firms with which they conduct business. It provides information on the professional background, including disciplinary history and customer complaints, of more than 1.2 million current and former brokers. More than 29 million broker searches were conducted on BrokerCheck in 2014, with approximately 18.9 million summary records viewed and approximately 7 million downloads of detailed reports on brokers. BrokerCheck represents the single most complete source of information about brokers available to the public.<sup>2</sup>

FINRA Rule 8312 (BrokerCheck Disclosure Rule) governs the information FINRA releases to the public via BrokerCheck. This information is derived from FINRA's Central Registration Depository (CRD<sup>®</sup>) system, a central licensing and registration system for the U.S. securities industry.<sup>3</sup> FINRA makes publicly available through BrokerCheck a significant portion of the information reported in CRD. Since establishing BrokerCheck, FINRA has regularly assessed the scope and utility of the information it provides to the public and has made changes to improve the program and expand the scope of information available to the public.<sup>4</sup>

Given that BrokerCheck is considered to be the most comprehensive source of information available to investors about brokers' professional histories, it is important to examine the value of BrokerCheck information to investors and to assess whether BrokerCheck would be enhanced by the inclusion of additional non-public information.<sup>5</sup>

Accordingly, FINRA's Office of the Chief Economist has examined the following research questions:

- i. Do investors already have access to valuable information about brokers through BrokerCheck?
- ii. Would including additional non-public CRD information enhance the value of BrokerCheck to investors?

Our detailed analysis is set forth in the Office of the Chief Economist working paper titled, "Do Investors Have Valuable Information About Brokers?", which is available at <http://www.finra.org/industry/chief-economist>. Here we provide an overview of the working paper, including its research methodology, data and a discussion of key findings.

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1. The views expressed in this summary and the working paper upon which it is based are those of the authors and do not necessarily reflect the views of FINRA or of the authors' colleagues on FINRA staff.
  2. Certain states also make publicly available information about brokers licensed to do business in their state. However, state regulators differ on what information is released because each state is governed by its own public records laws. In addition, most states only provide information about brokers licensed by that state.
  3. Information in CRD is obtained through the Uniform Forms that brokers, brokerage firms and regulators complete as part of the securities industry registration and licensing process and is collected on behalf of the SEC, state securities regulators and FINRA. The Uniform Forms in CRD contain information about qualification, employment and disciplinary records of brokers and firms. See the [Current Uniform Registration Forms for Electronic Filing in Web CRD](#) page for information on the Uniform Forms.
  4. For example, BrokerCheck provides information about qualifications (*i.e.*, registrations or licenses, if any, and industry exams the broker has passed), a list of registered securities firms where the broker is currently and/or was previously registered, the broker's employment history for the last 10 years (both in and outside the securities industry), and a disclosure section that includes information about customer disputes, disciplinary events and financial matters on the broker's record.
  5. We note that some public commenters have argued that BrokerCheck is materially incomplete and should provide the public with additional information collected in the CRD system.

## Methodology

To assess the value of information available to investors through BrokerCheck, we examine whether the information on BrokerCheck can allow an investor to effectively discriminate between brokers associated with investor harm from other brokers.

We measure investor harm using complaints filed by customers against their brokers. Since some customer complaints may lack merit or suitable evidence of investor harm, we only count complaints that led to awards against brokers or settled above a minimum dollar level.<sup>6</sup> This allows us to focus our analysis on outcomes that are likely associated with material investor harm. Less than 1.5 percent of the brokers in our sample meet this definition of being associated with investor harm in the fourteen-year period under review. In this context, harm does not imply malfeasance on the part of the broker. Instead it only identifies instances where a third party (regulator, arbitrator or the firm) considered the claim to be worthy of remuneration.

In the technical language of statistics, we pose the research question as whether the information on BrokerCheck can reliably predict which brokers are more likely to have a harm event. We estimate the ability of the information already on BrokerCheck to predict investor harm events (“baseline” predictive power) using well-established statistical models and techniques, capturing the ability of the model to correctly predict those brokers who are and are not associated with harm events.

To evaluate the impact of including additional sets of non-public CRD information on BrokerCheck, we test the incremental power of such information to predict investor harm (as we define the term) without increasing misidentification above and beyond the “baseline” of what is currently on BrokerCheck. The four sets of non-public information we evaluate relative to the baseline are:

- ▶ harm associated with coworkers, a measure derived from data already on BrokerCheck, designed to capture the occurrence of investor harm associated with other brokers at brokers’ firms;
- ▶ exam performance, including FINRA qualification exam scores and number of times a broker failed the exams;
- ▶ undisclosed financial events, including satisfied judgment and liens and bankruptcies more than 10 years old; and
- ▶ undisclosed disciplinary events, including firm internal reviews, and closed or dismissed regulatory actions, investigations and civil judicial actions.

## Sample

We examined a subset of CRD data during the 2000-2013 period.<sup>7</sup> Specifically, our sample includes 181,133 brokers who registered with FINRA in 2000 or later. We wanted to limit the sample to brokers who have direct dealings with the public. Since currently there is no identifier in CRD to indicate that the broker has retail clients, we included those brokers with more than three state registrations for at least half of their registration tenure as a proxy.

To construct a series of annual views for these brokers, we aggregated disclosure events and other information for each broker during each calendar year in the 2000-2013 period. The annual sample includes 1,014,873 broker-year observations, based on data publicly released on BrokerCheck as well as other non-public CRD data.

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6. We use the CRD settlement threshold for reporting customer complaints on Uniform Forms of \$10,000 for complaints that settled prior to May 18, 2009, and \$15,000 for settlements thereafter. To account for the possibility that some firms may still treat settlement at these dollar levels as *de minimis*, we also consider alternative measures based on \$25,000 or higher thresholds. Our results do not change materially with these higher thresholds.

7. We begin our sample in 2000, the first full year after Web CRD was introduced in mid-1999. We end it in 2013 to allow sufficient time for customer complaints to reach a resolution, such as a settlement or an award.

## Key Findings

We find that the information currently available to investors through BrokerCheck, including disciplinary records, financial and other disclosures, and employment history, has significant power to predict investor harm. The 20 percent of brokers with the highest predicted probability of investor harm are associated with more than 55 percent of the investor harm events in our sample. The proportion of total dollar harm represented by these harm events is more than 55.5 percent suggesting that our predictions capture economically meaningful events and not merely smaller events.

We also examined the tradeoff between correctly predicted outcomes of investor harm events associated with individual brokers (true positives) and cases where the model incorrectly predicts investor harm (false positives).<sup>8</sup> For example, we find that the model correctly predicts 71.1 percent of the investor harm events at a false positive rate of 33 percent.<sup>9</sup> Overall, these results suggest that BrokerCheck provides valuable information to investors, thereby allowing them to discriminate brokers with a high propensity for investor harm from other brokers.

With respect to the impact of additional non-public CRD information on BrokerCheck, we find that our measure of harm associated with coworkers increases the overall power of the model to predict investor harm. For example, the percentage of investor harm events corresponding to the 20 percent of brokers with the highest predicted probability of investor harm increases from 55.5 percent to 58.9 percent and the proportion of dollar harm predicted increases from 55.7 percent to 57.1 percent when this measure is included in our model. Overall, our results suggest that information about harm associated with coworkers increases the ability to discriminate between brokers associated with investor harm and other brokers, and that this increase is also economically meaningful.<sup>10</sup> We find that including undisclosed financial events or undisclosed disciplinary events does not lead to an economically meaningful increase in the predictive power of our model. Moreover, we find that exam performance generally leads to a reduction in predictive power.<sup>11</sup>

We compare the predictive power of information about harm associated with coworkers to that of disclosures currently made public on BrokerCheck.<sup>12</sup> This analysis indicates that information about harm associated with coworkers is not only important relative to the non-public CRD information we evaluate in our working paper, but also significant compared to disclosures that are already released on BrokerCheck. These results suggest that investors may benefit from having access to information about harm associated with coworkers on BrokerCheck.

Our results do not imply that brokers' histories are the most accurate or "best" way to predict investor harm events, but only show that this information has economically meaningful predictive power. We note that regulators may have access to additional non-public information, such as information collected during examinations or investigations, which could enhance their ability to detect and predict rules violations and protect investors.

If you have any questions about this research, please contact the Office of the Chief Economist at [ChiefEconomist@finra.org](mailto:ChiefEconomist@finra.org).

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8. False positives can be interpreted as the opportunity cost to investors of erroneously limiting the pool of brokers with which they may conduct business. Although, for an investor, failing to predict investor harm would likely be more costly than mistakenly avoiding a broker not associated with investor harm (false positive cases), our analysis shows that an investor would need to avoid multiple false positive cases for every true positive case avoided.
  9. These findings are robust to alternative measures of investor harm and other sensitivity analyses, discussed in the working paper. For example, we test the sensitivity of these results out-of-sample. As discussed in Section 4.3 of the working paper, our out-of-sample tests confirm the robustness of these results.
  10. As discussed in Section 5 of the working paper, including our measure of harm associated with coworkers increases the proportion of dollar harm predicted (corresponding to the scaled probably cut-off, IH-Score, of 1) from 73.5 percent to 77.2 percent, and this 3.7 percent increase in dollar harm predicted accounts for awards and settlements of more than \$18 million. This finding suggests that the increase in predictive power from this measure is also economically important.
  11. For example, the proportion of investor harm events corresponding to the 20 percent of brokers with the highest (ex-ante) predicted probability of investor harm decreases from 55.5 percent to 55.1 percent and the proportion of dollar harm predicted decreases from 55.7 percent to 54.6 percent when exam performance is included in our model. See the working paper, Table 5.
  12. These disclosures include disclosed financial events, criminal events and disciplinary events as well as information about association with expelled firm.