Misconduct and the Market Implications of Honest Advisors' Decisions

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December 23, 2022

Abstract

Previous literature has studied the factors that influence investment advisor misconduct. However, most advisors have not engaged in misconduct. We establish that advisors with clean records are likely to leave firms that exhibit increased misconduct to firms with fewer occurrences. This decision of honest advisors has important market implications by affecting the flow of AUM and the matching between firms and advisors in relation to misconduct. We demonstrate that in an industry where reputation and trust are central, being affiliated with a firm that experiences misconduct elevates reputational concerns and threatens future cash flows. Changes in local economic conditions, the firms' responses, changes in enforcement, or competing firms reaching out to the advisors do not drive honest advisors' decisions to leave. Further, we perform instrumental variable and diff-in-diff analyses to estimate a firm's misconduct occurrences.

Keywords: Financial Misconduct, Investment advisor, Separations, Reputation

JEL: D14, D18, G20, G24, G38, J44, K42, L22, M53

[1] We would like to thank to Linda Allen, Douglas Cumming, Stephen G. Dimock, Andrew Ellul, Will Gerken, Umit Gurun, Jonathan Karpoff, Noah Stoffman, Fei Xie, Scott Yonker for their helpful comments on and suggestions for this paper. We would like to thank Mark Egan, Gregor Matvos, and Amit Seru for providing us with advisors' data.
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1. Introduction

As many investors in the United States use financial advisors for their investment decisions, the financial advisory industry manages $28 trillion worth of assets (Hung Clancy, Dominitz, Talley, Berribi and Suvankulov, 2008; Gurun, Stoffman, and Yonker, 2021). Yet, financial advisors are often perceived as dishonest and consistently rank among the least trustworthy professionals (e.g., Edelman Trust Barometer, 2015; Zingales, 2015). Clients in the investment advisory industry are sensitive to trust shocks (Gurun, Stoffman, and Yonker, 2018), and reputation is especially important in this industry. While the literature focuses extensively on the factors that influence advisor misconduct,[2] 90% of investment advisors do not engage in misconduct, and no misconduct instances occur in 75% of the branches in a given year.

This paper analyzes the effect of misconduct occurrences on the firm's honest advisors. We define advisors as 'honest' if they have not been involved in misconduct and are employed in firm-counties devoid of misconduct occurrences in a given year.[3] We establish that in an industry in which reputation and trust are central, honest employees are more likely to leave firms that exhibit elevated instances of misconduct and move to firms with fewer occurrences. Unlike those involved in misconduct, who are usually hired by firms that tolerate such behaviors (Egan et al., 2019), honest advisors are not constrained to a specific firm type. They have clean records and do not

[2] Although investment advisors must put their clients' best interests before their own, the compensation structures used in this industry create incentives for misconduct (Inderst and Ottaviani, 2009; Stoughton, Wu, and Zechner, 2011). The primary factors of financial misconduct include individual level characteristics (Clifford, Ellis, and Gerken, 2019; Dimmock, Gerken, and Van Alfen, 2021; Egan, Matvos, and Seru, 2019; Kowaleski Sutherland, and Vetter, 2020), co-worker influence (Dimmock, Gerken, and Graham, 2018), firm level effects (Liu, 2016; MacLean, 2008; Nguyen, Hagendorff, and Eshraghi, 2016), the impact of local competition and market structure (Gelman, Khan, Shoham, and Tarba, 2021), the adoption of the Broker Protocol (Clifford and Gerken, 2021; Gurun et al., 2021), the importance of the regulatory jurisdiction (Charoenwong, Kwan, and Umar, 2019) and the influence of the economy (Law and Zuo, 2021). Egan Matvos, and Seru (2022) study firm discipline following misconduct.

[3] Dimmock et al. (2018) show a positive impact of advisors who work in the same branch of a firm (co-workers) on an individual's propensity to commit misconduct. To avoid any co-worker influence and given the fact that advisors have a persistent tendency to engage in misconduct (Egan et al., 2019), we focus only on firm-counties devoid of misconduct occurrences.

want to be associated with misbehaviors caused by others in the firm. This enables us to explore their decisions by observing their choices and focusing on reputational concerns, apart from social interactions with coworkers and other influencing factors. We show that misconduct-related reputational concerns–and threats to future stream of cash flow–as well as a lower opportunity costs associated with moving to another firm, affect the decision to leave.

The honest advisors' decision to leave firms following misconduct has important consequences. First, we show that the arrival of those advisors to a new firm positively affects its AUM growth. The results indicate that they are more skilled, which implies the incurred cost of misconduct to firms, which has not been shown so far in the literature. Another consequence is the matching between firms and advisors in relation to misconduct (Egan et al., 2019). Firms with incidence of misconduct have a smaller pool of honest advisors and are left with more dishonest ones. Respectively, we find a positive association between honest advisors leaving dishonest firms (following out-of-county misconduct occurrences) and the probability of dishonest firms hiring dishonest advisors in the same county. This is especially important in counties with unsophisticated consumers that are more likely to exhibit misconduct, indicating additional welfare consequences.

Our data set pertains to a panel of individual US investment advisors for 2005-2017. It includes detailed annual data about each investment advisor's full employment history in the industry and the disclosure history of any disciplinary events. The data covers over 430,000 advisors working for more than 30,000 firms, yielding over 3.8 million employee-year observations. To classify the individual advisor misconduct disclosed by the firms, we follow the methodology of Egan et al. (2019).

We start our analysis at the firm level, finding that the honest advisor separation rates are positively associated with the firm's instances of out-of-county misconduct. The magnitudes are found to be meaningful. Firms with at least one case of misconduct in the previous year exhibit an increase of 63% in the share of separations among their honest advisors (relative to the baseline separations rate).

A natural question arises regarding what drives the separations observed in the wake of elevations in the firm's instances of misconduct. We show that honest advisors choose to move to other firms, which holds beyond alternative explanations related to local areas, firms, or regulations. First, potential specific changes in local economic or demographic conditions may correlate with elevated instances of honest advisor separation following firm misconduct. These temporary or permanent local characteristics may drive varying responses by the advisors or their clients. To this end, we perform a firm-county specification with firm, county, and time fixed effects and add a variety of county-level controls to account for any time-invariant local characteristics. We also perform this specification with county x time fixed effects to account for county-level time-variant changes. Our results do not change in both specifications, meaning that specific local circumstances do not drive the separations of honest advisors.

Another option is that the degree of misconduct is related to the firm's specific situation, which may induce its managers to initiate structural revisions of its policies or internal monitoring, implement pay cuts or even layoffs. In turn, these revisions, rather than the level of misconduct itself, may increase the separations of honest advisors. Thus, we analyze the share of separations recorded among honest advisors at the firm-county level as a function of the number of a firm's misconduct occurrences in a given year, including firm x time, county, and time fixed effects. The firm's interaction with the time fixed effects helps us account for any possible firm-level time-

variant changes while capturing county time-invariant characteristics—such as demand for investment advisory services, client characteristics—and general economic factors.[4] The results hold after including those fixed effects, meaning that changes in the firm are not the main driver.

Finally, the observed separations could be caused by potential changes in regulation or enforcement. As regulators play an important role in the financial system—and in the advisory industry specifically—their response may be affected by rising numbers of misconduct instances in the area (of their own initiative, due to clients' complaints, or following political pressure). The FINRA and the SEC regulate large advisory firms at the county level (already included in the time-fixed effects). In order to account for the regulation of medium and smaller firms, which is conducted at the state level, we add state x year fixed effects to the firm-county specification. Our results do not change—i.e., regulation changes do not drive honest advisor separations following enhanced misconduct instances in the firm.

Thereafter, we study the advisor's decision regarding which firm to move to. To this end, we analyze the number of instances of misconduct recorded for the advisor's new firm in relation to those recorded for her previous one. We include individual, time, and county fixed effects, as well as the previous and the new firm fixed effects. This extended set of fixed effects helps us capture any time-invariant individuals' characteristics, the demand for investment advisory services and client characteristics, general economic factors, and both firms' characteristics. We find that honest advisors move to firms with fewer instances of misconduct.

This indicates that the results in this paper are not driven by advisors who performed misconduct that had not been uncovered yet. We would expect that individuals that are concerned with more intense monitoring following misconduct instances would leave to firms with higher

[4] We count the number of misconduct occurrences at the firm-state level to avoid any issues of collinearity with the firm x time fixed effects.

tolerance to misconduct, not less. Additionally, the majority of the honest advisors were never involved in misconduct—even after moving to another firm— thus, this is less likely to be the driver of the results.

Next, we discuss honest advisors concerns regarding potential damage to their reputations—they have clean records and do not want to be associated with misbehaviors caused by others in the firm—and potential monetary losses following misconduct occurrences in the firm. As reputation is the opinion that people have about someone, it is challenging to capture it. Therefore, we provide extensive evidence to support this channel. First, awareness of misconduct instances is essential in our story. We show that better information flow enhances the likelihood of honest advisors to leave the firm. Then, we display that the degree of reputational damage increases the propensity to leave the firm if the sensitivity to misbehavior is high. Further, we demonstrate that the opportunity cost associated with leaving the firm negatively affects the decision, as being affiliated with a firm that experiences misconduct threatens future cash flow streams.

To estimate the degree of awareness regarding the misconduct—as a function of the information flow—we analyze misconduct cases that occur geographically closer, in areas with higher social connectedness (based on Bailey, Cao, Kuchler, Stroebel, and Wong, 2018), in bigger and more central counties, and more prominent firms. To this end, we perform the specification at the advisor level with individual, firm, time, and county fixed effects. We find that those honest advisors are more likely to leave firms in all those cases, as the probability of becoming aware of such occurrences is higher.

The sensitivity to misbehavior is an important factor affecting honest advisors' reputational concerns, as investors are sensitive to trust shocks in this industry (Giannetti and Wang, 2016; Gurun et al., 2018). The effect is expected to be higher among more sophisticated clients, who are

also more likely to respond by pulling their money out. Respectively, we perform the individual level specification and establish that the propensity of honest advisors to leave firms following out-of-county misconduct occurrences is higher in areas with more sophisticated clients, where the potential damage to reputation is higher. Further, the effect of misconduct on separations is more pronounced in states with lower corruption rates (Glaeser and Saks, 2006), where sensitivity to crime is higher. Advisors operating in these states have stronger reactions to misconduct.

Firm misconduct provides information regarding the potential decline of a firm's reputation, further increasing the sensitivity to misbehavior. Respectively, we find that spikes in a firm's misconduct occurrences above its long-term average increase the propensity of its honest advisors to leave. In this context, we analyze the special case of firms that exhibit instances of misconduct for the first time and show that the negative news embodied in first-time misconduct positively influences the likelihood of honest advisors to leave. Moreover, misconduct occurrences in which the dishonest advisor remains employed in the firm are associated with more separations. Those cases indicate that the firm's managers do not act in full force to prevent the recurrence of such instances, thus increasing reputational concerns.

However, the information flow and the sensitivity to misconduct will not affect the honest advisor if her opportunity cost to leave the firm is high. Employees are not inclined to do it because leaving a firm is usually followed by a complicated cost-benefit analysis. Analyzing the likelihood of leaving a firm as a function of an honest advisor's tenure, we find that long-tenured employees are less likely to leave (consistent with Cotton and Tuttle, 1986). They work with a wider client base and, on average, serve in higher positions, thus facing a higher cost of leaving the firm. Another supporting evidence of the influence of lower opportunity cost is shown in an analysis of a subsample of firms that adopt the Broker Protocol. It enables clients to follow their advisors to

other member firms without fear of litigation, making it easier for advisors to move between firms. Consistent with the lower opportunity cost, we find those honest advisors are more likely to move between Protocol firms following misconduct in the firm, as about 40% of client assets follow advisers when they move (Gurun et al., 2021).

The honest advisors' decision to leave firms following misconduct has important consequences. First, we show that the arrival of an honest advisor to a new firm positively affects its AUM growth. To this end, we match between firms based on different observables and focus on firms that do not exhibit previous significant annual growth in AUM. The idea is to compare similar firms, and avoid including firms with a significant positive growth trend before the new advisors join. Performing the specification at the advisor level, we find that firms to which honest advisors move following misconduct in their previous firms exhibit a bigger change in AUM in the consecutive two years compared to any other case of a new advisor that moves to a different firm. The result remains consistent also when comparing to honest advisors that move to another firm *not* following misconduct instances in the previous firm, after including firm-county-year fixed effects, and for a subsample of small advisory firms in which we can observe the effect of the arrival of the new advisor more clearly. These results indicate that honest advisors that leave the firm following misconduct are more skilled, which affects the cost of misconduct to firms that have not been shown so far in the literature.[5]

Another consequence is the matching between firms and advisors in relation to misconduct. Performing an analysis at the individual level, we find a positive association between honest advisors leaving dishonest firms following out-of-county misconduct occurrences and the

[5] Optimally, to assess the skill of the advisor, we would like to observe an outflow of AUM from the advisor's previous firm. However, there is no available AUM data at the branch level. At the firm level, we cannot separate whether the AUM outflow from the advisor's previous firm stems from misconduct or honest advidor leaving the firm.

probability of a dishonest firm hiring a dishonest advisor in the same county. We include advisor, year, county, and firm fixed effects. The result also holds after analyzing at the county level, with the county's total number of dishonest advisors hired by dishonest firms as the dependent variable (the same explanatory variable). We argue that dishonest firms are left to hire more dishonest advisors, which contributes to the explanation why dishonest companies employ higher percentages of dishonest advisors (Egan et al., 2019). The effect also holds in counties with unsophisticated consumers that are more likely to exhibit misconduct occurrences, indicating additional welfare consequences.

Our analysis may raise a concern that honest advisors do not initiate the move to another firm, but rather the honest firms contact them with offers to leave. We address this concern in two ways. First, if advisors were to receive attractive offers from other firms, we would not find differences among different subsamples in the opportunity cost analysis, as there is no reason to expect that the offers are correlated with the subsamples. Additionally, we test whether our main results hold in a loose labor market. This alternative explanation is less valid when many advisors are looking for a job while firms hire less. To this end, we verify that the results of the main specification hold only for the years of the financial crisis in 2008-2009. We also utilize the heterogeneity in the state-level employment in the finance and insurance NAICS industry to perform the specification only for the bottom quintile of state-year employment, and find consistent results.

Further, various other factors can affect employee decisions to switch firms. Thus, variables that we do not observe in this setting may drive our results. Firm misconduct may correlate with the honest advisors' decisions to leave directly or through unobserved factors. The timing in which the advisor chooses to leave the firm may also correlate with unobserved factors, such as changes in personal circumstances (family matters, etc.) or those actively looking for new jobs regardless.

We mitigate the scope of alternative explanations for our findings in two ways. First, we construct an instrumental variable (IV) for a firm's misconduct instances based on the 2010 change made to the investment advisor qualification exam, which removed coverage of the rules and ethics section. Kowaleski et al. (2020) show that advisors who passed the exam without the ethics section are more likely to commit misconduct. Therefore, our IV for the firm's misconduct occurrences is the proportion of a firm's newly hired advisors who passed the exam without the ethics section out of the total newly hired advisers.[6] We perform the individual level specification from 2011 with the IV and find that honest advisors are more likely to leave following misconduct in the firm.

Additionally, we perform a Diff-in-Diff analysis using the shift in regulatory jurisdiction over 'midsize' investment advisors from the SEC to state securities regulators as an exogenous shock. Charoenwong et al. (2019) show that this change in regulatory jurisdiction increased the probability of misconduct in midsize firms. We follow the methodology of the authors by identifying the treated group as midsize investment advisory firms ($25m- $100m in AUM) and the control group consisting of large firms (firms with AUM between $100m and $1b and then the control group includes firms with AUM between $100m-$300m). Performing the individual level specification, we mirror the previous results.

Our paper contributes to the literature on financial advisor misconduct by focusing on the largest section of the advisor pool, the honest ones. As presented above, most of the extant literature deals with the factors that increase the likelihood of advisor misconduct (see the first footnote for the main literature). We add to this literature by focusing on the advisor's reputational concerns apart from her social interactions with coworkers (Dimmock et al., 2018). We show that

[6] Both the numerator and the denominator include only the firm's out-of-county newly hired advisors.

the firm's out-of-area misconduct instances can lead honest advisors to leave their current workplaces for firms with less misconduct.

Trust and reputation are important in the financial advisory industry. We supplement the literature on the matching between firms and advisors in relation to misconduct. Egan et al. (2019) establish that firms with a greater incidence of misconduct are more likely to employ advisors with past misconduct records. We analyze the complementary part, establishing that honest advisors tend to leave firms following heightened misconduct cases and move to firms with fewer instances. Such steps help advisors preserve their good reputation. This contributes to the explanation why some companies employ much higher percentages of honest advisors than others. We also show that this has a meaningful effect on the flow of AUM between firms.

The paper also contributes to the labor finance literature. This strand of the literature studies the impact of financial factors on human capital. Human capital differs from other forms of capital because it cannot be owned (except in the extreme case of slavery). Thus, employees can engage in strategic behaviors and leave the firm due to financial factors like leverage (Matsa, 2018) or financial distress (Baghai, Silva, Thell, and Vig, 2020). We isolate and zoom into one reason for separation that to the best of our knowledge has not been hitherto identified. It enables us to add a new factor that affects honest employees' strategic decisions to leave: to avoid being tainted by bad apples. We show its importance, as our results can apply to other professions, such as doctors or academics.

This paper proceeds as follows. Section 2 outlines our data and variables. In Section 3, we present our examination of the influence of the firm's misconduct instances on honest advisor separations. Section 4 shows that honest advisors choose to leave a firm in the wake of heightened occurrences of misconduct in the firm. Section 5 presents the honest advisor's decision using an

individual-level analysis and shows that firm's misconduct is an important factor. Section 6 describes the mechanism that drives honest advisors to leave—i.e., to avoid reductions in future cash flow steam due to reputational damage. In Section 7, we show the broader market implications. Section 8 deals with endogeneity issues, while Section 9 presents our main conclusions.

2. Data and Variables

2.1. Sample construction and main variables

Our data set contained a panel of individual US investment advisors covering the years 2005-2017. It is constructed from publicly available data drawn from the SEC's Investment Advisor Public Disclosure (IAPD®) website.[7] Our data set includes detailed information on each investment advisor's complete employment history in the industry and the disclosure history of any disciplinary events. The data covered over 30,000 firms and more than 430,000 advisors. In total, our sample exceeded 3.8 million employee-year observations.

To classify individual advisors' misconduct—disclosed by investment advisement firms as required by the FINRA—we follow the methodology of Egan et al. (2019). We focus on six categories: Customer Dispute–Settled, Regulatory–Final, Employment Separation after Allegations, Customer Dispute–Award/Judgment, Criminal–Final Disposition, and Civil–Final. For each advisor each year, we use a dummy variable that indicates whether there was an instance of misconduct in that firm and a dummy variable to account for the advisor having a past record of misconduct.

[7] The data set is constructed using the methods reported in Egan et al. (2018, 2019). We would like to thank the authors for providing us with the data. In our research, we focus only on investment advisors.

Our goal was to analyze the impact of out-of-county misconduct occurrences on the separations of honest advisors. We define advisors as honest if they have not been involved in misconduct and are employed in firm counties without misconduct occurrences as of a given year. We manually matched the relevant county using the city and state details of each advisor employed every year.

As we aim to analyze the effect of out-of-county misconduct occurrences, our sample includes only firms that operate in more than one county. We also exclude any massive separations of advisors, which usually occur following M&As or firm defaults.

The outcome variable includes the separation rate among honest advisors, which we calculate—first at the firm and then at the firm-county level—as the share of honest advisors who leave a firm (firm-county) each year out of the total number of honest advisors employed (firm-county) at the end of the previous year. We also used a dummy variable to indicate—at the advisor level—whether or not they leave a firm in a given year.

Our main explanatory variable is the firm's out-of-county misconduct occurrences, estimated as the log of 1 plus the total number of instances of misconduct occurring in a firm each year. Another independent variable is an indicator of whether a firm has at least one case of misconduct in a given year. Additionally, we calculate the difference between a firm's occurrences of misconduct in a given year and its long-term median misconduct to show the impact of misconduct spikes above a firm's long-term trend. Further, we estimate the effect of out-of-county misconduct on honest advisor separations as a function of where the misconduct occurs by evaluating the average distance between the honest advisors' employment locations and those of the advisors who engaged in misconduct in a given year. We also use the county-level social connectedness index of Bailey et al. (2018), constructed using aggregated information from the

universe of friendship links between all Facebook users. For each county of the honest advisor, we calculate the social index with the county where the firm's misconduct occurs.

We control for firm-county-year, county-year, and firm-year level characteristics. At the firm-year level, we estimate a firm's size using two indicators: the total number of advisors it employs each year and the number of counties in which it operates. At the aggregate level, the more advisors a firm employs and the more geographically distributed it is, the higher its aggregate market power. We also calculate the average tenure (in years) of a firm's advisors and its share of female ones[8]. Such honest advisors' characteristics may influence the decision to leave the firm.

We control for a variety of county-year characteristics. To control for the level of misconduct in a county, we calculate the log of 1 plus the total number of instances of misconduct recorded in a county in a given year. Based on the advisors' dataset, we construct the average level of competition at the year-county level using the concentration ratio (HHI) defined by Gelman et al. (2021). Further, to evaluate the in-county options available to advisors—i.e., other firms to which to move—we use the number of firms operating in a county. Additionally, we control for county-level changes in the housing pricing index (HPI) published by the Federal Housing Finance Agency (FHFA) and estimate using sales prices and appraisal data. The HPI highlights specific county-level economic conditions that may influence advisor perceptions of wealth (Dimmock et al., 2021) and decisions on employment issues.

Other county-level control variables include total county population size, obtained from the Bureau of Economic Analysis (BEA); county financial sophistication, estimated as the county's proportion of retirees out of its total over-25 population based on census data; county-level

[8] The dataset contained the names of the advisors, but did not provide information on their gender. We thus used Egan et al.'s (2019) gender classification, based on data from GenderChecker, to estimate the gender of each advisor based on their given names.

unemployment rate, drawn from the Bureau of Labor as a proxy for the financial strength of the county's population; and the average level of income per capita, obtained from the BEA. To highlight the degree to which news of misconduct may potentially spread to other counties, we also distinguish between urban and rural ones. We define rural counties as those with a population of at least 25% rural (based on census data).

Further, at the firm-county-year level, we control the firm county's size, calculated as the number of advisors employed in a firm in each county in a given year. At the state level, we evaluate the level of corruption by using the crime rates drawn from Glaeser and Saks (2006).

2.2. Summary statistics

Table 1 presents the summary statistics of our main variables. Around 90% of our sample advisors were not involved in misconduct. Almost 10% of our sample's honest advisors leave their firm each year. Despite the high dispersion, most counties were home to more than one active advisory firm. Thus, those honest advisors that decided to move to another firm often found alternatives within the same county.

Insert Table 1 here.

The average number of instances of misconduct at the firm level is 0.13, with a high inter-firm heterogeneity; thus, around 10% had recorded at least one case of misconduct. On average, our sample firms operate in 15 counties.

3. The effect of misconduct on honest advisor separations

3.1. Firm-level specification

We start our analysis by investigating the influence of the firm's out-of-county misconduct occurrences on honest advisor separations based on the following firm-level empirical specification:

$$\%Separations_{ft} = \beta_1 Firm\ misconduct_{ft-1} + \beta_2 K_{ft-1} + \alpha_f + \alpha_t + \varepsilon_{ft} \quad (1)$$

Where f is the firm and *t* is the year. $\%Separations_{ft}$ stands for the honest advisor separation rate at the firm level, estimated as the proportion of honest advisors that left a firm in year *t* out of the total number of honest advisors employed by the same firm in year *t-1*; $Firm\ misconduct_{ft-1}$ stands for the one-year-lagged total misconduct occurrences in a given year. Alternatively, we use a one-year lagged indicator of a firm's instances of misconduct as the explanatory variable. It is 1 for at least one case of misconduct in a firm in a given year and 0 otherwise; K_{ft-1} stands for the firm-level one-year lagged control variables that may have influenced the separation rates (as defined in Section 2). To capture firm size, we include the lagged number of a firm's advisors and the lagged total number of counties in which the firm was operating. We also include the lagged average tenure (in years) of a firm's advisors and its one-year lagged share of female advisors; a_f is the firm-fixed effect, which accounts for time-invariant firm-specific characteristics (such as compensation structure, firm culture, and a firm's internal sanctioning of misbehavior), α_t is the year-fixed effect that controls for the macro factors that influence all firms in a given year, and ε_{ft} is the error term. We cluster standard errors by firm. Table 2 presents the effect of misconduct on the firm's honest advisor separations.

Insert Table 2 here.

We find that, for a given firm, honest advisor separation rates are positively associated with instances of the firm's out-of-county misconduct. The coefficients are positive and significant both with and without the control variables, performing the specification with the number of a firm's misconduct occurrences and the dummy variable. The magnitudes are also meaningful. Those firms with at least one case of misconduct in the previous year exhibit an increase of 1% in the share of separations among their honest advisors, a 63% variation relative to the baseline separation rate.

Analyzing the control variables, the results are consistent with the previous literature on job stability. We find that our proxy for firm size—the number of advisors employed by a firm—negatively influences honest advisor separations. Larger firms were found to exhibit more stable employee bases as both their advisor turnover rates and cash flows were more stable over time. An employee's job security typically relies on their firm's financial health (e.g., Benmelech, Bergman, and Enriquez, 2012). Larger firms tend to provide better job security and be more financially stable over time.

Cotton and Tuttle (1986) found clear and significant evidence of tenure being strongly and negatively related to separation by performing a general meta-analysis on employee separation. The longer an employee works for a firm, the less likely they are to move to another. Additionally, employees value job security due to the cost involved in being laid off (Matsa, 2018). In this regard, we found that longer average advisor tenures are associated with lower honest advisor separation rates. We further discuss it in section 6.3.1.

4. Honest advisors leave the firm

In this section, we discuss possible explanations for the observed honest advisor separations. We show that honest advisors choose to move to other firms following heightened misconduct,

and this correlation holds beyond any alternative explanation related to local economic and demographic changes (Section 4.1), the firm (Section 4.2), or regulations (Section 4.3).

4.1. Changes in local economic or demographic conditions

Specific local economic or demographic conditions, or changes in them, maybe correlated with increased separations of honest advisors following misconduct. These temporary or permanent local characteristics could elicit different responses from the advisors themselves and, possibly, their clients. To this end, we perform the following firm-county level specification.

$$\%Separation_{fct} = \beta_1 Firm\ misconduct_{ft-1} + \beta_2 K_{ct-1} + \beta_3 K_{fct-1} + \beta_4 K_{ft-1} + \alpha_f + \alpha_c + \alpha_t + \varepsilon_{fct} \quad (2)$$

Where f is the firm, c is the county, and t is the year. $\%Separations_{fct}$ stands for the honest advisor separation rate, estimated as the share of honest advisors that left a firm-county in year *t* out of the total number of honest advisors employed in the firm-county in year *t-1*; $Firm\ misconduct_{ft-1}$ stands for the one-year-lagged total misconduct occurrences recorded by a firm; K_{ct-1} stands for the county-level control variables defined in Section 2—the total number of misconduct instances recorded in a county, the sophistication level of a county's clients, the average income per capita, changes in housing prices, the concentration level of in the investment advisory industry in the county, a county's unemployment rate, and a county's population; K_{fct-1} stands for the number of advisors employed by a firm in a county; K_{ft-1} is the same as in equation (1); a_f is the firm fixed effects, which accounts for any possible firm-level time-invariant characteristics; α_c is the county-fixed effect, which controls for any local factors influencing all firms, advisors, and client in a given county; α_t stands for the time-fixed effects; and ε_{fct} for the error term. We cluster standard errors by firm and county.

Insert Table 3 here.

Column 1 in Table 3 presents the results. We find a positive relationship between the firm's out-of-county misconduct and honest advisor separation rates. An increase of one standard deviation in out-of-county firm misconduct instances is associated with a 34% increase in the likelihood of honest advisor separation (relative to the baseline separation rate). As we include various county-level control variables, the result indicates that local economic or demographic conditions cannot fully explain this effect.

Additionally, we perform the firm-county specification in Equation (2) with county x time, firm, state, and time fixed effects (instead of county, firm, state, and time fixed effects) to account for time-variant changes in local economic or demographic characteristics. Column 2 in Table 3 presents the results. We find a similar positive association between a firm's misconduct and honest advisor separations. The magnitude of such association is greater than that in Column 1, whereby an increase of one standard deviation in the firm's out-of-county firm-state misconduct instances is associated with a 51% increase in the likelihood of honest advisor separation.

As the effect holds in those specifications, we conclude that specific local circumstances do not drive honest advisor separations.

4.2. Firm response

The degree of misconduct may correlate with the specific situation of a firm. It may spur managers to initiate structural revisions in their firm's policies or internal monitoring, implementing pay cuts or even layoffs. In turn, such revisions may result in increased honest advisor separations rather than lowering the level of misconduct. Changes in a firm's work environment, policies, or procedures may increase the propensity of some honest advisors to leave, also given the fact that better performing advisors are likely to be targeted by other firms.

Hence, we analyze the proportion of separations among honest advisors by performing the specification at the firm-county level (equation 2), including firm x time, county, state, and time fixed effects. A firm's interaction with time fixed effects helps us to account for any possible firm-level time-variant changes. We change the explanatory variable to $Firm\ state\ misconduct_{ft-1}$, which stands for the one-year lagged firm misconduct occurrences in a state. We use firm-state-level misconduct instances to avoid collinearity with the firm x time fixed effects. To account for state-level time-invariant differences, such as the degree of regulation, supervision, and enforcement, we add state fixed effects to the specification.

Column 3 in Table 3 presents the results. We find that the positive effect of the firm's out-of-county misconduct on honest advisor separations holds after the inclusion of those fixed effects, meaning that changes in the firm do not drive it. A 1% increase in the firm's out-of-county firm-state misconduct instances is associated with an 8.5% increase in the likelihood of honest advisor separation (relative to the baseline separations rate). Although the firm-year fixed effects reduce the magnitude, it is still statistically significant and economically relevant.

4.3. Changes in regulation or enforcement

Another potential cause of increased separations following misconduct occurrences could be regulation or enforcement changes. As regulators play an essential role in the financial system—and in the advisory industry specifically—their response may change following rises in instances of misconduct in specific areas or a particular firm. In both cases, the level of supervision may increase and affect policies and procedures, thus requiring advisors to spend more time dealing with different regulatory requirements. Such changes in the level and nature of supervision may be instigated by the regulator's own initiative, client complaints, or political pressure. This, in turn, may increase the propensity of some advisors to move to other firms.

The FINRA and the SEC regulate large advisory firms (as already included in the time fixed effects in Equation 2). Thus, we add state x year fixed effects to the firm-county specification in equation (2)—besides the firm, county, and time fixed effects—to account for the regulation of medium and smaller firms, which is conducted at the state level. Column 4 in Table 3 presents the results. We find a positive relationship between misconduct and honest advisor separations, which indicates that regulatory changes do not drive our results.

5. The individual's decision to leave the firm

The previous sections showed that the honest advisor separation rates observed in the wake of heightened out-of-county instances of misconduct are not driven by the firm, local changes in the economy, or regulation. In section 5.1, we present an indication that misconduct is an important factor in honest advisors' decisions by showing that they tend to move to firms that have recorded fewer misconduct occurrences. Section 5.2 shows that our findings at the firm and the firm-county levels also hold at the individual level, beyond the advisor's specific characteristics.

5.1. Misconduct occurrences in the new firm vs. the previous firm

Unlike their counterparts who have engaged in misconduct and are usually hired by firms that tolerate such behaviors (Egan et al., 2019), honest advisors are not constrained to a specific firm type. This enables us to explore their decisions by observing their choices and better understanding their considerations regarding which firm to move to. As we are interested in studying the influence of occurrences of misconduct, we analyze the number of instances of misconduct recorded in the advisors' new firms as a function of those reported in their previous ones. We perform the following individual-level specification, restricted to those honest advisors who have moved to other firms.

$$New\ firm\ misconduct_{f't} = \beta_1 Old\ firm\ misconduct_{ft-1} + \beta_2 K_{ft} + \beta_3 K_{fct} + \beta_4 K_{ct}$$

$$+ \alpha_i + \alpha_{f,} + \alpha_f + \alpha_c + \alpha_t + \varepsilon_{ifct} \quad (3)$$

Where $f \; and \; f'$ are the previous and the new firms, respectively, in which the advisor was employed, and *t* is the year. $New\ firm\ misconduct_{f't}$ stands for the total number of misconduct instances recorded for the new firm; $Old\ firm\ misconduct_{ft-1}$ stands for the total number of misconduct instances recorded for the previous firm in *t-1*. Our control variables include the sizes of both the new and previous firms, estimated by the total numbers of advisors employed by each in a given year, and the sizes of the previous and new firm counties. We also controlled for the options available to the advisors in their respective areas by estimating the number of firms operating in their counties. A greater number of firms active in a county provides an advisor with a broader set of options among which to choose and, eventually, to move to; We include individual, time, and county fixed effects, as well as the previous and new firm fixed effects. This extended set of fixed effects helps us capture individual time-invariant characteristics, the demand for investment advisory services and client characteristics, general economic factors, and both firms' characteristics. We cluster standard errors at the individual level.

Insert Table 4 here.

Table 4 presents the results. We find that those honest advisors who opt to move tend to choose firms with fewer misconduct instances. As a firm's fixed effects capture its average level of misconduct over time, the interpretation of our results is that honest advisors tend to move from firms that have experienced higher-than-average occurrences of misconduct to firms with fewer ones in a specific year. Honest advisors are sensitive to a firm's misconduct levels and react to any changes in the related trend.

The effect also holds when including county x time fixed effects, which account for any specific changes in local characteristics, such as economic or demographic ones. Column 2 in

Table 4 presents the results of this specification. We find that both the sign and the magnitude are similar, meaning that the results were not driven only by changes in a few specific areas.

Further, we are interested in studying whether honest advisors move to firms with fewer instances of misconduct, regardless of the average level recorded for each firm. To this end, we perform the same specification, but this time excluding the new and the previous firm-fixed effects. We find similar results (Column 3 of Table 4), meaning that honest advisors tend to move to firms with fewer misconduct occurrences. We then include county x time fixed effects again—instead of county-fixed ones—and find similar results (Column 4 of Table 4).

5.2. Individual-level specification

Next, we perform an in-depth analysis of our sample honest advisors' decisions to leave. We study the propensity of advisors to leave their firms as a function of the firms' out-of-county misconduct occurrences by performing the following specification at the individual level.

$$Separation_{ifct} = \beta_1 Firm\ misconduct_{ft-1} + \beta_2 K_{ft-1} + \beta_3 K_{fct-1} + \beta_4 K_{ct-1} + \alpha_i + \alpha_f + \alpha_c + \alpha_t + \varepsilon_{ifct} \quad (4)$$

Where i is the advisor, f is the firm, c is the county, and t is the year. $Separation_{ifct}$ is a dummy variable that is set to 1 if the honest advisor left the firm and to 0 otherwise; As before, $Firm\ misconduct_{ft-1}$ stands for the log of the one-year-lagged firm's out-of-county misconduct occurrences. The control variables are the same as in Equation (3). We include individual, time, county, and firm fixed effects and cluster standard errors at the individual level.

Insert Table 5 here.

Column 1 in Table 5 presents the results. Akin to our results at the firm and the firm-county level, we find a positive association between the honest advisors' propensity to leave their firms and the latter's out-of-county misconduct occurrences. A one standard deviation increase in the lagged log of misconduct increased the advisors' propensity to leave by 21% (relative to the

baseline separations rate). The effect remains meaningful after considering the advisors' specific characteristics (accounted for by the individual fixed effects), such as aversion to the risk of switching employers.

To further show that our sample honest advisors' decisions are not related to any time-variant local economic circumstances, such as changes in wealth (see Dimmock et al., 2021), we rerun the individual level specification by adding county x time-fixed effects. We find a similar effect, indicating that changes in local circumstances do not drive the results. Column 2 in Table 5 presents the results.

6. Why do honest advisors choose to leave following heightened firm misconduct instances?

Now we turn to focus on the honest advisors' concerns regarding potential damage to their reputations and potential monetary losses following misconduct occurrences in the firm. As reputation is the opinion that people have about someone, it is challenging to capture it. Therefore, we provide extensive evidence to support this channel. First, we show that better information flow enhances the likelihood of honest advisors leaving the firm (Section 6.1), increasing awareness of the misconduct instances. We analyze different dimensions of information flow: geographical distance, social connectedness between the area where the misconduct occurred and the location of the honest advisor, the centrality of where the misconduct occurs, and the firm's prominence. Then, we display that the degree of reputational damage increases the propensity to leave the firm if the sensitivity to misbehavior is high (Section 6.2). We study the influence of county sophistication, corruption rates, hikes in misconduct, and first-time instances in the firm, as well as whether the dishonest advisor stays in the firm. Further, we demonstrate that the opportunity cost associated with leaving the firm negatively affects the decision (Section 6.3). To this end, we focus on the advisor's tenure and a subset of firms that adopted the Broker Protocol.

6.1. Information flow

First, we show that better information flow enhances the likelihood of honest advisors leaving the firm, increasing awareness of misconduct instances. We analyze different dimensions of information flow: geographical distance (section 6.1.1), social connectedness between the area where the misconduct occurred and the location of the honest advisor (section 5.1.2), the centrality of where the misconduct occurs (section 6.1.3), and the firm's prominence (section 6.1.4).

6.1.1. Geographical distance

As we analyze misconduct instances within the firm but outside the county, social networks and media can make advisors aware of the instances. Social networks may affect the advisor's clients' behaviors, such as stock market participation (Brown et al., 2008; Hong et al., 2004), increasing the effect of out-of-county misconduct through better information flow. Increases in the likelihood of advisors becoming aware of misconduct occurrences lead us to expect out-of-county misconduct to have a greater effect if it occurs in closer geographical areas or more central counties (with higher potential media coverage). Thus, we perform the specification in Equation (4), changing our main explanatory variable to the log of the average distance between the honest advisor's employment location and those of the advisors who were engaged in misconduct in a given year.

Column 3 in Table 5 presents the results. We find that more distant misconduct occurrences have a weaker influence on honest advisor propensity to leave a firm. Because advisors may not become aware of occurrences in distant locations, their clients may also be unlikely to be exposed to them.

6.1.2. Social connectedness

Geographical proximity is not the only proxy for social networks. Social media can relate to geographically distant areas. To this end, we use the social connectedness index (Bailey et al., 2018), constructed using aggregated information from the universe of friendship links between all Facebook users. We use the aggregation data at the county level to study whether each of the firm's misconduct occurs in a county with a high or low social connectedness score with the county of the honest advisor. We define a high score for each county if its social connectedness score with the county of the honest advisor is above the median. We assume a better information flow regarding the misconduct among closely socially connected counties.

Hence, we perform the specification in Equation (4), changing the main explanatory variable to a dummy variable, whether the county of the honest advisor and the county where the misconduct occurred is highly socially connected. Column 4 in Table 5 presents the results. We find a positive coefficient, indicating that misconduct instances occurring in more socially connected counties increase the likelihood of the information flow. Respectively, they are associated with more honest advisors leaving their firms.

6.1.3. The centrality of the area where the misconduct occurred

If misconduct occurs in a central area, it is more likely to be covered by the media or discussed in social circles. Therefore, the information flow of those instances is expected to be higher. To analyze the influence of the centrality of the area in which instances of misconduct occur, we perform the specification in Equation (4) with the log of the lagged number of a firm's recorded instances of misconduct in rural counties as the main explanatory variable. Column 5 in Table 5 presents the results. We find a negative coefficient, meaning that misconduct instances occurring in more rural counties are associated with fewer honest advisors leaving their firms.

Additionally, we perform the specification in Equation (4), this time adding an interaction term between the number of a firm's instances of misconduct and the proportion of such instances occurring in rural counties in a given year. We also add the proportion of rural misconduct. Column 6 in Table 5 presents the results. Again, we find a negative coefficient, indicating that the effect of instances of misconduct is stronger when they occur in more central counties.

6.1.4. Firm's prominence

Another indication of the information flow of the misconduct instances can be derived from the firm itself. News on bigger and more famous firms is more likely to spread faster. Clients are more likely to relate negative information to the firm even if the misconduct occurs in other geographical areas. Hence, we use the firm's size to proxy how much the advisory firm is prominent. In those firms, the spread of information is expected to be wider and faster.

We add to the specification in Equation (4) an interaction term between the number of a firm's instances of misconduct and an indicator of whether the firm is prominent. Prominent firms are defined as those above the median annual AUM. We also added the firm's prominence as a control variable. In Column 7 of Table 5, we find a positive coefficient, indicating that the effect of misconduct is stronger when it occurs in more prominent firms.

6.2. Sensitivity to misconduct

In this section, we display that the degree of reputational damage increases the propensity to leave the firm if the sensitivity to misbehavior is high. To this end, we study the influence of county sophistication (section 6.2.1), corruption rates (section 6.2.2), hikes in misconduct and first-time instances in the firm (section 6.2.3), and whether the dishonest advisor stays in the firm (section 6.2.4).

6.2.1. County sophistication

Investor sensitivity to trust shocks (Giannetti and Wang, 2016; Gurun et al., 2018) can cause out-of-county misconduct occurrences to harm a firm's reputation. Such firm reputational damage is higher among more sophisticated clients, who are more likely to respond by pulling their money from the firm. To protect themselves from any potential reputational damage caused by others' misbehaviors and to avoid any potential monetary losses, honest advisors operating in such areas are more likely to move to other firms.

Hence, we analyze the advisor's propensity to leave a firm as a function of the client's financial sophistication level. We add the interaction between a firm's out-of-county misconduct occurrences with the county clients' level of sophistication to the specification in Equation (4). We also include the county's average sophistication level, calculated as the log of the one-year lagged proportion of retirees out of a county's total over-25 population.

Insert Table 6 here.

Column 1 in Table 6 presents the results. We find that, in counties with more sophisticated clients, honest advisors are more likely to move to another firm. In Column 2 of Table 6, we show that our results also hold with county x time fixed effects, which account for any time-variant local characteristics, indicating that a specific subset of areas does not drive the findings.

6.2.2. Sensitivity to crime

Next, we turn to analyze the sensitivity of advisors to crime and misbehavior. Glaeser and Saks (2006) show the heterogeneity in state crime rates and that different types of crime are more likely to be concentrated in specific states. In addition, Liu, Moldogaziev, and Mikesell (2017) show that the level of corruption between states is significant. Meier and Holbrook (1992)

demonstrate that any differences in corruption found between states result from cultural and historical factors, meaning that some states are more tolerant of crime than others.

People are more used to crime in some areas; accordingly, we expected to find a lower sensitivity to misconduct of the advisors operating in them. This, in turn, would reduce their propensity to leave a firm following a rise in occurrences of misconduct. Therefore, we add the state corruption rate (Glaeser and Saks, 2006) and its interaction with a firm's total instances of misconduct to the individual-level specification in Equation (4).

Column 3 in Table 7 presents the results. As expected, we find the effect of misconduct on advisor separations to be more pronounced in states with lower corruption rates—i.e., where sensitivity to crime is higher. Respectively, advisors operating in such states tend to react more strongly to misconduct.

6.2.3. Changes in misconduct from the long-term trend

A firm's instances of misconduct provide information regarding the potential worsening of its culture and reputation. In this regard, we study the effect of misconduct spikes by performing the specification in Equation (4), changing the main explanatory variable to the difference between the misconduct occurrences recorded for a firm in a given year and its long-term misconduct level. We find that increases in misconduct cases above the long-term average enhance the likelihood of honest advisors leaving a firm. Column 4 in Table 6 presents the results.

In this context, we analyze the special case of those firms that exhibit misconduct instances for the first time. We thus investigate the effect of first-time misconduct occurrences by adding to the specification in Equation (4) an interaction between the firm's misconduct instances with an indicator set to 1 if a firm had exhibited at least one case of misconduct in a given year for the first time and to 0 otherwise. Column 5 in Table 6 shows that the coefficient of the interaction term is

positive, meaning that the implications of misconduct occurrences positively influence honest advisor propensity to leave a firm.

6.2.4. Dishonest advisor stays in the firm

Now we turn to analyze how the reaction of the firm's managers to the misconduct instance, and specifically whether the advisor was laid off following misconduct. When the firm handles the misconduct more seriously, it signals to the rest of the firm's advisors and the clients regarding its tolerance to such occurrences. When the advisor who committed the misconduct remains employed in the firm, even if the punishment is meaningful, it is more problematic for other advisors to explain it to the clients and justify the decision. It might also be the case that other advisors are not fully aware of the dishonest advisor's punishment. Thus, we use the indication of whether the dishonest advisor stays in the firm, as the damage to reputation and the sensitivity to misconduct is more severe in cases where the dishonest advisor continues to be employed in the firm.

To this end, we add to the specification in Equation (4) an interaction between the firm's misconduct occurrences with an indicator set to 1 if the dishonest advisor stays in the firm and 0 otherwise. We also add the indicator as a control variable. Column 6 in Table 6 shows that the coefficient of the interaction term is positive, meaning that less strict punishments positively influence honest advisor probability of leaving a firm.

6.3. Advisor's opportunity cost

The previous sections showed that information flow and the sensitivity to misconduct affect the honest advisor's propensity to leave the firm. However, leaving a firm is usually followed by a complicated cost-benefit analysis. Thus employees are not inclined to do it, especially if her

opportunity cost to leaving the firm is high. Therefore, this section provides evidence that lower opportunity cost positively affects the advisor's decision to leave by analyzing the honest advisor's tenure (section 6.3.1) and firms that adopted the Broker Protocol (section 6.3.2).

6.3.1. Advisor's tenure

First, we analyze the likelihood of leaving a firm as a function of an honest advisor's tenure. Longer-tenured employees become more connected to their firm and are less likely to leave it (Cotton and Tuttle, 1986). They work with a wider client base and, on average, serve in higher positions, thus facing a higher cost of leaving. It may also be more difficult for them to find positions in different firms.

Insert Table 7 here.

To investigate the influence of tenure, we perform the individual level specification in Equation (4), adding an interaction between honest advisor tenure (in years) and firm instances of misconduct. We also control for the advisor's tenure. Column 1 in Table 7 presents the results. Consistent with their high opportunity cost, we find that long-tenured honest advisors are less likely to leave firms following misconduct instances.

6.3.2. Firms that adopted the Broker Protocol

Gurun et al. (2021) examined firm-level variations in the adoption of the Broker Protocol. It enables clients to follow their advisors to other member firms without fear of litigation, making it easier for advisors to move between firms. In this regard, about 40% of clients' AUM follow their advisors when they move.

We thus study this unique setup, which makes it easier for advisors to move to other firms while keeping a significant proportion of their client bases. We use the subsample of our firms

that adopted the Broker Protocol to replicate our individual-level specification in equation (4). Columns 2 and 3 in Table 7 present the results.

We mirror our main result on the positive effect of misconduct on advisor decisions to move to other firms (Column 2). Observing the interaction between the level of sophistication found in a county and the level of misconduct recorded, we once more find the effect to be more pronounced in counties with more sophisticated clients (Column 3). These results serve as supporting evidence of the influence of lower opportunity cost.

7. Market implications

The honest advisor's decision to leave the firm following misconduct has important consequences. In section 7.1, we discuss the effect on the excess flow of AUM to the firms that the honest advisors move. In section 7.2, we analyze the implications on the matching between firms and advisors in relation to misconduct.

7.1. Flow of AUM

First, we show that the arrival of an honest advisor to a new firm positively affects its AUM growth. To this end, we focus on firms that do not exhibit previous significant annual growth in AUM, i.e., below the median AUM growth in the previous year. Additionally, the match between firms is based on different observables: size, number of advisors, number of branches, misconduct instances, and the number of same counties. The idea is to avoid including firms with a significant positive growth trend even before the new advisors join and to compare similar firms. Panels A and B in Table 8 present the results of the panel regressions at the individual level in Equation (4) for the consecutive two years firm's AUM growth. In Panel A, the main explanatory variable is a dummy equal to one if an honest advisor joins the firm following misconduct in the previous firm and zero for any other case of a new advisor that moves to a different firm. In Panel B, the main

explanatory variable is a dummy equals one if an honest advisor joins the firm following misconduct in the previous firm, and zero for honest advisors that move to another firm *not* following misconduct instances in the previous one.

Insert Table 8 here.

In both sections, we find that firms to which honest advisors move following misconduct in their previous firms exhibit a bigger change in AUM in the consecutive two years compared to any other case of a new advisor that moves to a different firm. The results remain consistent after including firm x county x time fixed effects (Columns 2,4 in each Panel) and for a subsample of small advisory firms (operating in less than five counties) in which we can observe the effect of the arrival of the new advisor more clearly (Columns 3,4 in each Panel). These results indicate that honest advisors that leave the firm following misconduct are more skilled, which affects the cost of misconduct to firms.[9]

7.2. Dishonest advisors and dishonest firms

The honest advisor's decision to leave the firm following misconduct also affects the matching between firms and advisors in relation to misconduct. To show it, we perform an analysis at the individual level in Equation (4), changing the outcome variable to a dummy variable equals one if a dishonest advisor is hired by a dishonest firm in a county and zero otherwise. The main explanatory variable is the natural logarithm of the number of honest advisors that leave firms following misconduct at the county. Panel C of Table 8 presents the results.

In Column 1 of Panel C, we find a positive association between honest advisors leaving dishonest firms following out-of-county misconduct occurrences and the probability of a dishonest

[9] Optimally, to assess the skill of the advisor, we would like to observe an outflow of AUM from the advisor's previous firm. However, there is no AUM data at the branch level. At the firm level, we cannot separate whether the AUM outflow from the advisor's previous firm stems from misconduct of honest advidor leaving the firm.

firm hiring a dishonest advisor in the same county. The result remains consistent when analyzing only counties with less sophisticated clients in Column 2.

Additionally, we perform a similar analysis at the county level, with the county's total number of dishonest advisors that were hired by dishonest firms as the dependent variable. The main explanatory variable is the natural logarithm of the number of honest advisors that leave firms following misconduct at the county (the same explanatory variable as in Columns 1 and 2). We include county and year fixed effects, and control for the total number of misconduct instances in the county, number of firms, and advisors operating in the county. We find consistent results to the previous ones, both in all counties (Column 3 of Panel C in Table 8) and in counties with less sophisticated clients (Column 4). We argue that dishonest firms are left to hire more dishonest advisors, which contributes to the explanation why dishonest companies employ much higher percentages of dishonest advisors (Egan et al., 2019). The effect also holds in counties with unsophisticated consumers that are more likely to exhibit misconduct occurrences, indicating additional welfare consequences.

8. Mitigating the scope of alternative explanations

Various other factors can affect decisions to switch employers. Some unobserved variables could have driven our results. A firm's misconduct can be correlated—either directly or through unobserved factors—with honest advisors' decisions to leave. The timing with which an advisor chooses to leave a firm can also correlate to unobserved factors, such as changes in personal circumstances (family matters, etc.) or to a subset of advisors who had been actively looking for new jobs regardless.

In the previous sections, we showed that our results hold for different specifications at the firm, firm-county, and individual levels. We also used one-year-lagged instances of misconduct

and added a variety of control variables. Additionally, at the firm-county level, we used firm x time, county x time, and state x time fixed effects. The advisor-level regression included individual, firm, county, and time fixed effects. In this section, we present our mitigation of the scope for alternative explanations for our findings, which we perform by addressing them more directly in three ways. First, we address the alternative explanation that honest advisors do not initiate the move to another firm, but rather the honest firms contact them with offers to leave (section 8.1). We also take an IV approach (section 8.2), and we separately perform a diff-in-diff analysis (section 8.3). We mirror our previous results, meaning that out-of-county instances of misconduct in the firm positively impact honest advisor decision to leave.

8.1. Honest advisors do not initiate the move to another firm

Our analysis may raise a concern that honest advisors do not initiate the move to another firm, but rather the honest firms contact them with offers to leave. We address this concern in two ways. First, if advisors were to receive attractive offers from other firms, we would not find differences among different subsamples in the opportunity cost analysis, as there is no reason to expect that the offers are correlated with the subsamples. Further, we test whether our main results hold in a loose labor market. This alternative explanation is less valid when many advisors are looking for a job while firms hire less. To this end, we verify in Columns 1 and 2 of Panel A in Table 9 that the results of the specification in equation (4) hold only for the years of the financial crisis in 2008-2009.

Insert Table 9 here.

We also utilize the heterogeneity in the state-level employment in the finance and insurance NAICS industry to perform the specification for the bottom quintile state-year employment and find consistent results in Columns 3 and 4 of Panel A in Table 9.

8.2. IV analysis for firm misconduct

First, we construct an instrumental variable for a firm's instances of misconduct based on the 2010 change made to the investment advisor qualification exam, which removed the rules and ethics section coverage. Kowaleski et al. (2020) show that those advisors who passed their exam without the ethics section are more likely to engage in misconduct. Hence, our IV for a firm's misconduct instances is the proportion of newly hired advisors who passed their exam without the rules and ethics section out of the total newly hired advisors by the firm. This measure correlates with misconduct (instrument relevance). Both the numerator and the denominator include only a firm's out-of-county newly hired advisors. It is not related to honest advisor decisions to leave (exclusion restriction).

We perform our individual level specification in equation (4) on data from 2011 onward (after the change in the qualification exam) using the IV for a firm's misconduct levels. Column 1 in Panel B of Table 9 presents the results. We find that honest advisors are more likely to leave the firm following increases in fitted firm out-of-county misconduct. In Column 2, we present the results of our IV analysis but change from county to county x time fixed effects to account for any specific area's potential influence on advisor decisions. The coefficient of the fitted firm's instances of misconduct remains positive, meaning that changes in specific areas do not drive our results.

8.3. Diff-in-diff analysis

Additionally, we performed a Diff-in-diff analysis using the shift in regulatory jurisdiction over midsize investment advisory firms from the SEC to state-securities regulators as an exogenous shock. Charoenwong et al. (2019) show that this regulatory jurisdiction change increased the likelihood of misconduct in midsize firms.

Suppose the new regulator's guidelines and requirements for both the firms and the advisors themselves had been stricter than those of the SEC. In that case, the change in the regulatory jurisdiction could have increased the likelihood of honest advisors leaving. However, this is not the case, as the state regulators are found to be less strict than the SEC, and the instances of misconduct have increased.

We closely follow the methodology of Charoenwong et al. (2019). Our treated group includes midsize investment advisory firms $25m- $100m in AUM), while the control group consists of big firms. We perform the specification twice, once with the control group, including firms with AUM between $100m and $1b, and then with it, including firms with AUM between $100m and $300m. As Charoenwong et al. (2019), we exclude from the sample the two states (New York and Wyoming) in which midsize firms were not subject to the change in regulatory jurisdiction.

We performed our individual-level specification in equation (4), changing the main explanatory variable from the firm's misconduct instances to *Treat x After*. *After* is a dummy variable set to 1 for the three years following the change in regulatory jurisdiction (2012-2014) and to zero for the three years before the change (2009-2011). We mirror the previous results in Columns 3 and 5 of Panel B in Table 9 by finding a positive effect of misconduct on the propensity of honest advisors to leave.

A looser regulatory regime might drive honest advisors to leave regardless of a firm's misconduct. Although we do not believe this to be a viable argument in this case—and have shown earlier that regulation changes do not drive our results—we address this concern by including county x time fixed effects in the specification. As presented in Columns 4 and 6 of Panel B in Table 9, our results remain similar.

9. Conclusions

This paper studied the effect of the firm's out-of-county misconduct occurrences on its honest advisors. Our investigation of how honest advisors are influenced by misconduct is novel due to the fact that most of the extant literature has dealt with dishonest advisors and the factors that cause misconduct. We found that honest advisors are more likely to leave those firms that exhibit higher out-of-county misconduct occurrences and move to firms with fewer such instances. We claim that honest advisors tend to leave firms due to elevated concerns regarding their reputations and future cash flows. We provided extensive evidence for this concern, showing that information flow regarding the misconduct, higher sensitivity to misbehavior, and lower opportunity cost increase the likelihood of honest advisors to leave their firms.

The new factor established in this paper regarding the influence of misconduct in the firm on employee strategic decisions to leave can apply to other professions, such as doctors or academics. We isolate and zoom into one reason for separation that nobody has been hitherto able to identify to the best of our knowledge. We contribute to the explanation why some companies employ much higher percentages of honest advisors than others.

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Table 1: Descriptive statistics

We report the descriptive statistics of the main variables at the individual-year level, aggregated at the firm-county-year and firm-year levels. Our sample includes data on investment advisors for the years 2005-2017.

VARIABLES	(1) N	(2) mean	(3) sd	(4) min	(5) max
Separation propensity of an honest advisor	2,147,776	0.094	0.29	0	1
Total firm's misconduct	248,602	0.127	3.32	0	688
Num. firm's advisors	248,602	15.35	322.25	1	28,570
Num. firm's advisors with no misconduct	248,602	13.67	284.46	1	23,438
Num. counties of the firm	248,602	15.09	308.04	1	27,190
Average tenure of the firm's advisors (years)	248,602	7.59	5.08	0	55
First time misconduct in the firm (among firms with misconduct)	248,602	0.78	0.41	0	1
Num. advisors firm-county	709,416	5.38	25.6	1	1,874
Retirees ratio	30,953	0.207	0.032	0.06	0.497
Num. firms in a county	30,953	252.2	447.02	1	2,596

Table 2: The effect of firm misconduct on honest advisors' separations (firm-level analysis)

The table presents the results of the panel regressions in Equation (1) for honest advisor separations at the firm level, estimated as the proportions of honest advisors who left their firms in year *t* out of the total honest advisors employed in year *t-1*. Our main explanatory variable is *Lag log num. firm misconduct* (Columns 1 and 2), measured as the one-year lagged total misconduct occurrences in a given year. We also show the results for indicator *Lag dummy of firm misconduct* as the explanatory variable, set to 1 for at least one case of misconduct in the firm in a given year, and to 0 otherwise (Columns 3 and 4). In Columns 1 and 3, we include only the main explanatory variables, and in Columns 2 and 4, we include the following controls: *Lag log num. firm's advisors*, which is the one-year lagged total number of investment advisors employed in the firm; *Lag advisors' average tenure*, calculated as the one-year lagged average years of tenure among the firm's advisors; *Lag num. firm's counties* which is the one-year lagged total number of counties in which the firm was operating; and *Lag female advisor percentage* is the share of female advisors out of the firm's total number of advisors. We include firm and time fixed effects. Standard errors (in parentheses) are clustered by firm. *p<0.1; **p<0.05; ***p<0.01.

	(1)	(2)	(3)	(4)
VARIABLES	%Separations honest advisors			
Lagged log num. firm misconduct	0.012***	0.008**		
	(0.004)	(0.004)		
Lagged dummy of firm misconduct			0.005**	0.011***
			(0.003)	(0.003)
Lagged log num. firm's advisors		-0.063***		-0.063***
		(0.003)		(0.003)
Lagged advisors' average tenure		-0.003***		-0.003***
		(0.000)		(0.000)
Lagged num. firm's counties		0.000		0.000
		(0.000)		(0.000)
Lagged female advisor percentage		0.003		0.003
		(0.005)		(0.005)
Observations	169,629	169,629	169,629	169,629
R-squared	0.286	0.305	0.286	0.305
Firm FE	YES	YES	YES	YES
Year FE	YES	YES	YES	YES

Table 3: Advisor leave the firm following misconduct occurrences (firm-county analysis)

The table presents the results of the panel regressions in Equation (2) for honest advisor separations at the firm-county level, estimated as the proportion of honest advisors who left the firm-county in year *t* out of total honest advisors employed in the firm-county in year *t-1*. Our main explanatory variable is *Lag log num. firm misconduct* (Columns 1, 2, and 4), measured as the one-year lagged total misconduct occurrences in a given year. In Column 3, the explanatory variable is *Lag log num. firm-state misconduct* calculated as the one-year lagged firm's total misconduct occurrences in a given year in the state. We include control variables at the firm, county and firm- county levels. In Column 1, the specification includes firm, time, and county fixed effects. In Column 2, the specification includes firm, time, and county x time fixed effects. In Column 3, the specification includes firm x time, time, state, and county fixed effects. In Column 4, the specification includes firm, time, county, and state x time fixed effects. Standard errors (in parentheses) are clustered by firm and county. *p<0.1; **p<0.05; ***p<0.01.

	(1)	(2)	(3)	(4)
VARIABLES	%Separations honest advisors			
Lag log num. firm misconduct	0.008**	0.012***		0.008**
	(0.003)	(0.003)		(0.003)
Lag log num. firm-state misconduct			0.0015**	
			(0.001)	
Controls	YES	YES	YES	YES
Observations	156,656	153,745	300,868	156,656
R-squared	0.258	0.291	0.137	0.262
Firm FE	YES	YES		YES
County FE	YES		YES	YES
Year FE	YES	YES	YES	YES
State FE			YES	
County X Year FE		YES		
Firm X Year FE			YES	
State X Year FE				YES

Table 4: New vs. previous firm misconduct

This table presents the results of our panel regressions in Equation (3) for the annual occurrences of misconduct in the new firm (which the advisor joined), calculated as the log of 1 plus the amount of misconduct at the firm level. *Log num. misconduct previous firm* is the total number of misconduct instances in the previous firm in year *t-1* (which the advisor left). The control variables include the size of the new and the previous firms, estimated by the total number of advisors employed in each firm in a given year, and the size of the previous and new firm-counties. Additionally, we control for the advisor's options to move to other firms by including the number of firms operating in the county. Column 1 includes individual, county, time, and previous and new firm fixed effects. Column 2 includes individual, county x time, time, and previous and new firm fixed effects. Column 3 includes individual, county, and time fixed effects, and column 4 includes individual, county x time, and time fixed effects. Standard errors (in parentheses) are clustered by individual. *p<0.1; **p<0.05; ***p<0.01.

	(1)	(2)	(3)	(4)
VARIABLES	Log num. misconduct new firm			
Log num. misconduct previous firm	-0.094***	-0.098***	-0.199***	-0.100***
	(0.008)	(0.008)	(0.009)	(0.008)
Controls	YES	YES	YES	YES
Observations	70,284	64,553	82,027	65,117
R-squared	0.981	0.985	0.719	0.985
Individual FE	YES	YES	YES	YES
Year FE	YES	YES	YES	YES
County FE	YES		YES	
Previous firm FE	YES	YES		
New firm FE	YES	YES		
County x Year FE		YES		YES

Table 5: Information flow

This table presents the results of our panel regressions at the individual level in Equation (4) for honest advisor propensity to leave a firm following misconduct. *Lag log num. firm misconduct* is the one-year lagged log of the total number of misconduct instances in the firm. *Log misconduct distance* is the average distance between the honest advisor's employment location and those of the advisors who had engaged in misconduct in a given year. *Misconduct in a socially connected area* is an indicator of whether the firm's misconduct occurs in a socially connected area with the county of the honest advisor (based on the Social connectedness Index). A connected social area is defined as counties with Social Connectedness Index scores above the median. *Lag log num. firm misconduct in rural counties* represents the one-year lagged log of a firm's misconduct occurrences in rural counties. *Percent misconduct in rural counties* is calculated as the firm's proportion of instances of misconduct occurring in rural counties. *Prominent firm* is a dummy variable equals one for the top 50% firms by AUM and 0 otherwise. The control variables include the number of advisors employed in the firm and the firm-county and the number of firms in the county. Columns 1 and 3-7 include individual, county, time, and firm fixed effects. Column 2 includes individual, firm, time, and county x time fixed effects. Standard errors (in parentheses) are clustered by individual. *p<0.1; **p<0.05; ***p<0.01.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
VARIABLES	Does honest advisor leave the firm?						
Lag log num. firm misconducts	0.010***	0.009***				0.022***	0.000
	(0.001)	(0.001)				(0.001)	(0.001)
Log misconduct distance			-0.003***				
			(0.001)				
Misconduct in a socially				0.003***			
connected area				(0.000)			
Lag log num. firm misconducts					-0.004***		
in rural counties					(0.001)		
Lag log num. firm misconducts						-0.001***	
x %misconduct in rural counties						(0.000)	
Lag log num. firm misconducts							0.023***
x Prominent firm							(0.001)
Controls	YES	YES	YES	YES	YES	YES	YES
Observations	1,838,852	1,835,361	1,261,473	528,902	1,483,977	1,256,292	1,838,852
R-squared	0.325	0.340	0.330	0.456	0.324	0.334	0.326
Individual FE	YES	YES	YES	YES	YES	YES	YES
Year FE	YES	YES	YES	YES	YES	YES	YES
County FE	YES		YES	YES	YES	YES	YES
Firm FE	YES	YES	YES	YES	YES	YES	YES
County x Year FE		YES					

Table 6: Sensitivity to misconduct

This table presents the results of our panel regressions at the individual level in Equation (4) for honest advisor propensity to leave the firm following misconduct. *Lag log num. firm misconduct* is the one-year lagged log of the total number of misconduct instances in the firm. *County sophistication* is calculated as the county's proportion of retirees out of the total county population of over 25. *State corruption rate* is state-level crime based on Glaeser and Saks (2006). *Lag log num. firm misconduct difference* represents the difference between the firm's number of current misconduct occurrences and its long-term average misconduct. *First time misconduct* is an indicator set to 1 if a firm exhibited at least one case of misconduct in a given year and 0 otherwise. *Dishonest advisor stays in the firm* is an indicator of whether the advisor who committed the misconduct remained employed in the firm. Columns 1 and 3-6 include individual, county, time, and firm fixed effects. Column 2 includes individual, firm, time, and county x time fixed effects. Standard errors (in parentheses) are clustered by individual. *p<0.1; **p<0.05; ***p<0.01.

	(1)	(2)	(3)	(4)	(5)	(6)
VARIABLES	Does honest advisor leave the firm?					
Lag log num. firm misconducts	0.075***	0.073***				
x County sophistication	(0.005)	(0.006)				
Lag log num. firm misconducts			-3.109***			
x State corruption rate			(0.004)			
Lag log num. firm misconducts				0.001***		
difference				(0.000)		
Lag log num. firm misconducts					0.017***	
x First time misconduct					(0.000)	
Lag log num. firm misconducts x Dishonest advisor stays in the firm						0.006***
						(0.001)
Lag log num. firm misconducts	0.026***	0.024***	0.002***		0.002***	0.005***
	(0.001)	(0.001)	(0.000)		(0.001)	(0.001)
Controls	YES	YES	YES	YES	YES	YES
Observations	1,830,972	1,827,510	1,831,433	1,838,852	1,277,108	1,838,852
R-squared	0.325	0.340	0.901	0.326	0.334	0.328
Individual FE	YES	YES	YES	YES	YES	YES
Year FE	YES	YES	YES	YES	YES	YES
County FE	YES		YES	YES	YES	YES
Firm FE	YES	YES	YES	YES	YES	YES
County x Year FE		YES				

Table 7: Opportunity cost

This table presents the results of our panel regressions at the individual level in Equation (4) for honest advisor propensity to leave a firm following misconduct. *Honest advisor's tenure* is the advisor's tenure (in years) in the firm. *Lag log num. firm misconduct* is the one-year lagged log of the total number of misconduct instances in the firm. *County sophistication* is calculated as the county's proportion of retirees out of the total county population above the age of 25. All columns include individual, county, time, and firm fixed effects. Standard errors (in parentheses) are clustered by individual. *p<0.1; **p<0.05; ***p<0.01.

	(1)	(2)	(3)
VARIABLES	Does honest advisor leave the firm?		
			Protocol firms
Lag log num. firm misconducts x honest advisor's tenure	-0.001***		
	(0.000)		
Lag log num. firm misconducts	0.018***	0.007***	0.068***
	(0.001)	(0.001)	(0.003)
Lag log num. firm misconducts x county sophistication			0.294***
			(0.015)
Controls	YES	YES	YES
Observations	1,838,852	383,609	382,105
R-squared	0.326	0.354	0.355
Individual FE	YES	YES	YES
Year FE	YES	YES	YES
County FE	YES	YES	YES
Firm FE	YES	YES	YES

Table 8: Market implications

Panels A and B present the results of our panel regressions at the individual level in Equation (4) for the consecutive two years firm's AUM growth. In Panel A the main explanatory variable is a dummy equals one if honest advisor joins the firm following misconduct in previous firm, and zero for any other case of a new advisor that moves to a different firm. In Panel B the main explanatory variable is a dummy equals one if honest advisor joins the firm following misconduct in previous firm, and zero for honest advisors that move to another firm *not* following misconduct instances in the previous one. In Columns 1 and 2 we include all the firms, while in columns 3 and 4 we restrict the sample to firms with less than 5 counties. Columns 1 and 3 include individual, county, time, and firm fixed effects. Columns 2 and 4 include individual and firm x county x time fixed effects.
Columns 1 and 2 of Panel C present the results of our panel regressions at the individual level in Equation (4), changing the outcome variable to a dummy variable equals one if a dishonest advisor hired by a dishonest firm in a county, and zero otherwise. The main explanatory variable is the natural logarithm of the number of honest advisors that leave firms following misconduct at the county. Columns 3,4 of Panel C present a county-level specification for the natural logarithm of the number of dishonest advisors hired by dishonest firms in the county. The main explanatory variable is the natural logarithm of the number of honest advisors that leave firms following misconduct at the county. In Columns 1,3 we include all the counties, while in Columns 2,4 included only counties with above average proportion of retirees out of the total county population above the age of 25.
Standard errors (in parentheses) are clustered by individual. *p<0.1; **p<0.05; ***p<0.01.

	(1)	(2)	(3)	(4)
VARIABLES	2-year AUM growth			
Panel A	All firms		Small firms	
Honest advisor joins following misconduct in previous firm1	0.443**	0.764*	1.475**	4.891***
	(0.209)	(0.407)	(0.699)	(0.903)
Controls	YES	YES	YES	YES
Observations	3,908	782	849	377
R-squared	0.702	0.947	0.793	0.955
Individual FE	YES	YES	YES	YES
Year FE	YES		YES	
County FE	YES		YES	
Firm FE	YES		YES	
Firm X County X Year FE		YES		YES

	(1)	(2)	(3)	(4)
VARIABLES	2-year AUM growth			
Panel B	All firms		Small firms	
Honest advisor joins following misconduct in previous firm2	0.531***	1.347***	1.420*	3.046***
	(0.089)	(0.243)	(0.737)	(0.991)
Controls	YES	YES	YES	YES
Observations	73,218	45,809	1,634	735
R-squared	0.742	0.872	0.767	0.934

Individual FE		YES	YES	YES	YES
Year FE		YES		YES	
County FE		YES		YES	
Firm FE		YES		YES	
Firm X County X Year FE			YES		YES

	(1)	(2)	(3)	(4)
VARIABLES	Dishonest advisor hired by dishonest firm?		Log num. dishonest advisors hired by dishonest firms	
	All	Less	All	Less
Panel C	counties	sophisticated	counties	sophisticated
Log num. honest advisors that leave firms following misconduct at the county	0.001***	0.001***	0.082***	0.061***
	(0.000)	(0.000)	(0.003)	(0.004)
Controls	YES	YES	YES	YES
Observations	2,157,635	2,157,635	30,899	20,508
R-squared	0.930	0.955	0.971	0.967
Individual FE	YES	YES		
Year FE	YES	YES	YES	YES
County FE	YES	YES	YES	YES
Firm FE	YES	YES		

Table 9: Causality

This table presents the results of our panel regressions at the individual level in Equation (4) for honest advisor propensity to leave a firm following misconduct. Columns 1 and 2 in Panel A present the the results only for the loose labor market during the years of the financial crisis (2008-2009), while Columns 3 and 4 present the results only for the bottom quintile state-year employment in the finance and insurance NAICS.
In columns 1 and 2 of Panel B we present the results of the 2SLS specification from 2011 onward, in which the IV of the firm's misconduct occurrences is its proportion of newly hired advisors passing the exam without the rules and ethics section out of the total newly hired advisors. In Columns 3 and 4 of Panel B, we present the results of the diff-in-diff specification, where *Treat* is set to 1 for midsize advisory firms ($25m- $100m in AUM) and to 0 for large firms (AUM between $100m and $1b). *After* is set to 1 for the first three years following the implementation of the change in regulatory jurisdiction (2012-2014) and to 0 for the years 2009-2011. In columns 5 and 6 of Panel B, we rerun the diff-in-diff, changing only the control group to firms with AUM between $100m and $300m.
Columns 1, 3, and 5 include individual, county, time, and firm fixed effects. Columns 2, 4, and 6 include individual, firm, time, and county x time fixed effects. Standard errors (in parentheses) are clustered by individual. *p<0.1; **p<0.05; ***p<0.01.

	(1)	(2)	(3)	(4)
VARIABLES	Does honest advisor leave the firm?			
Panel A	Financial crisis		Loose labor market	
Lag log num. firm misconducts	0.087***	0.083***	0.059***	0.058***
	(0.002)	(0.002)	(0.001)	(0.001)
Controls	YES	YES	YES	YES
Observations	224,848	224,124	367,770	367,072
R-squared	0.670	0.682	0.306	0.312
Individual FE	YES	YES	YES	YES
Year FE	YES		YES	
County FE	YES		YES	
Firm FE	YES	YES	YES	YES
County X Year FE		YES		YES

	(1)	(2)	(3)	(4)	(5)	(6)
VARIABLES	Does honest advisor leave the firm?					
Panel B	Instrumental Variable		Change in regulation		Change in regulation (2)	
Fitted Lag log num. firm misconduct	0.669***	0.692***				
	(0.038)	(0.042)				
Treat x After			0.024***	0.026***	0.016***	0.020***
			(0.002)	(0.002)	(0.002)	(0.002)
Controls	YES	YES	YES	YES	YES	YES
Observations	981,911	979,956	320,816	318,160	250,193	247,522
R-squared	0.841	0.865	0.388	0.416	0.399	0.437
Individual FE	YES	YES	YES	YES	YES	YES
Year FE	YES	YES	YES	YES	YES	YES
County FE	YES		YES		YES	

Firm FE	YES	YES	YES	YES	YES	YES
County x Year FE		YES		YES		YES