

University of Kentucky

Gatton College of Business and Economics

Institute for the Study of Free Enterprise



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## **Investment in Human Capital and Labor Mobility: Evidence from a Shock to Property Rights**

- **We show that the assignment of property rights to client relationships affects employee behavior in the industry for financial advice**
- **Our identification comes from staggered firm-level entry into the Protocol for Broker Recruiting**
- **The protocol effectively transfers the ownership of the client relationship from the firm to the employee**
- **We document that entering into the protocol increases employee labor mobility among member firms**
- **Further, we find that upon protocol inclusion, employees are less likely to generate customer complaints and more likely to invest in their own general human capital, but less likely to invest in firm-specific human capital**

Why would a firm allow an employee to take valuable assets out of the building upon their departure? In August 2004, three large financial advisory firms—Smith Barney, Merrill Lynch, and UBS—entered into a private agreement, the Protocol for Broker Recruiting (protocol), that allowed departing financial advisors to solicit their clients when moving to other protocol member firms without fear of legal recourse.<sup>1</sup> Over the next decade, over 1,500 firms joined this pact. In doing so, they willingly transferred their property rights in a key asset to their employees by effectively waiving preexisting non-solicitation clauses.

While patents and trademarks help to protect intellectual property rights for the firm, other forms of tacit human capital, such as relationships with clients, do not permit codification or armslength exchange. Though individual advisors often view the clients they work with as “their” clients, the legal reality is that they are clients of the financial advisory firm. This arrangement presents a distinction without a difference until an advisor wants to leave their employer. Given the inalienable nature of advisor-client relationships, firms may choose to protect this type of human capital through contractual mechanisms such as non-compete and non-solicitation agreements. While such agreements are generally found to deter employee exit, what effect they have on employee effort is less understood. If advisors are restricted from taking their clients when they leave a firm, then the client relationship is firm-specific human capital, and investment in the relationship may be inefficiently low due to a holdup problem (Grossman and Hart, 1986). In our paper, we study a shock that reassigns the ownership of this relationship to better understand the role of property rights and human capital investment.

Studying these issues empirically is challenging. Typically, whether a particular investment in human capital is general or firm-specific is an immutable characteristic. In the financial advisory industry, the advent of the protocol changed investments in client relationships from firm-specific to general human capital investments for some but not all advisors. Thus, advisors competing in the same geographic area at the same time have different specificity to their client-relationship investments. Moreover, we even observe this change in property rights within the same employee-employer relationship (job spell), allowing us to dismiss alternative explanations such as advisors selecting into protocol firms following their inclusion.

To study this industry, we obtain data from BrokerCheck and the Investment Adviser Public Disclosure (IAPD) database. These two databases allow us to track the career paths of 1.3 million unique advisors across more than 50,000 firms. The data give precise dates and branch locations on when individuals are employed with member firms, achieve professional advancement, receive customer disputes and other complaints of misconduct, and start new firms. Moreover, a series of standardized industry licenses allows us to track employee investments in human capital in a systematic manner. The data allow us to not only control for observable characteristics, but to use high dimensional fixed effects to control for unobservable heterogeneity across time, geography, firms, and individuals (and their interactions). Thus, we

argue that the introduction of the protocol makes an ideal context in which to study the effects of the assignment of property rights on the development of human capital.

Consider the example of two advisors working in the Raleigh, North Carolina, area: one works for UBS and one works for Edward Jones. Their offices are less than 400 feet away from each other and face each other, overlooking the 3700 block of Glenwood Ave. Each is positioned less than three miles from the prestigious Carolina Country Club, and they likely compete for the same clients. In 2004, executives in UBS's corporate offices in New York decided to join the protocol, while executives in Edward Jones's St. Louis office did not (and still had not by the end of our sample period). We test how, at that moment, the exogenous (to the advisor) change in property rights affects the UBS advisor's behavior relative to that of the Edward Jones advisor. Does the UBS advisor treat the client relationship differently now that he owns the asset? Does he seek additional licensing or career certification or leave to join a competing firm? We can control for observable characteristics (e.g., tenure in the industry) that may affect these choices, but given that we know the branch location of these two advisors, we can also use geographic fixed effects to control for unobservable heterogeneity in the Glenwood area of Raleigh that may influence these choices. Further, because protocol membership changes over time,<sup>2</sup> and thus the shock to property rights is staggered, we can compare workers at different firms at the same time, the same individual at different points in time, and even individuals at the same firm at the same time across geographical regions.

We first document that participation in the protocol affects labor mobility among financial advisors. Firms that join the protocol see turnover increase in their workforce, and the effect is more pronounced among more experienced advisors. We also see that firms are more likely to poach and be poached by other protocol firms, consistent with membership lowering the barriers to transfer between member firms. On net, protocol firms experience a growth in the number of employees, and these new hires tend to be more experienced. However, after joining the protocol, firms see an increase in the number of their existing advisors who decide to leave and start their own firms.

We next examine the behavior of the individual advisor. After an advisor's firm joins the protocol, granting the advisor property rights in the client relationship, we observe that the advisor takes better care of the asset, as evidenced by lower rates of customer disputes. Further, we find that advisors invest in their own human capital by sitting for additional industry licenses

that allow them to shift their business from a short-term, commission-based approach to a long-term, fee-based approach. We observe the actual exam scores for each advisor and find that employees perform better on these exams when their employer is in the protocol, suggesting that inclusion not only affects the extensive margin to invest in human capital, but the intensive margin as well. Finally, we find that advisors are less likely to obtain the Series 24 principal's license following protocol inclusion. This license grants an employee the ability to act in a supervisory role within the firm (approving new accounts, approving transactions, supervising branch employees, etc.), a role that may be difficult to transfer across different firms in the industry. Thus, as labor mobility improves, advisors appear to shift human capital investment to firms that are more easily transferable within the industry.

In each of these tests, we control for confounding variation by examining within-advisor, within-firm changes in these rates. We also address other time-varying explanations by controlling for the specific licenses an advisor gains over time as well as controlling for county-year fixed effects. These strategies allow us to rule out alternative explanations based on changes in business lines, regulatory phenomena, or economic conditions. In some specification, we focus on within-job-spell variation, which also rules out concerns about employee-employer matching.

We also examine the firm-level consequences associated with joining the protocol. We find within-firm evidence that revenues, assets under management, and number of accounts increase after joining the protocol; these increases remain even after accounting for the increase in number of employees. Given these results, a natural question to ask is, why do all firms not join? Firms may correctly fear that they will lose more human capital through employee exit than they will gain from attracting new advisors and increased production from existing advisors.

Our paper is related to a growing literature on labor restrictions and investment. Establishing a causal relationship between labor mobility and the actions of employees and firms is challenging. A series of papers utilizes geographic differences in enforceability (and, in some cases, time-series variation in enforceability due to judicial decisions) of post-employment covenants not to compete as a source of variation in mobility. Gilson (1999) examines differences between the enforceability of non-compete agreements in Silicon Valley and Massachusetts' Route 128 (Boston's technology corridor). He argues that the relative rise

of Silicon Valley over Route 128 is partially explained by California's unwillingness to enforce non-compete agreements, leading to increased labor mobility in Silicon Valley and increased knowledge spillovers between its firms. Garmaise (2011) finds that the use of non-compete contracts reduces labor mobility and binds human capital to the firm, but that these contracts affect the managers' incentives to invest in their own human capital, thereby reducing the value of the human capital stock. Jeffers (2017) also finds that the enforceability of non-compete contracts reduces labor mobility, but that enforceability is associated with an increase in capital investment by the firm, suggesting that reducing labor mobility may affect firms' capital stocks if replacing human capital is costly. Lavetti, Simon, and White (2017) show that by deterring the poaching of patients, non-compete agreements at physician practices increase the rate of return to job tenure. They argue that the evidence is consistent with non-compete agreements enabling practices to allocate patients to new physicians through intra-firm patient referrals, reducing a form of investment holdup. Barnett and Sichelman (2016) note that the enforceability of non-compete agreements is only one of many tools that firms may use to restrict labor mobility. Even in California, a state that bans the enforcement of non-competes, firms may use trade-secret litigation and deferred compensation to reduce mobility.

In contrast with non-compete agreements that prohibit a former employee from competing against a former employer for a specified amount of time, the non-solicitation agreements we examine are more narrowly aimed at preventing an employee from soliciting his former employer's clients. Therefore, the protocol allows us to isolate the effect of the value of the client relationship (which is subject to the non-solicitation agreement) from the employee's ability to work in the industry.

Our paper also contributes to the emerging literature on the financial advisory industry. Existing studies generally document that advisors do little to aid clients and instead harm performance by steering them toward high-fee products or the advisor's own personal biases (see, e.g., Bergstresser, Chalmers, and Tufano, 2009; Chalmers and Reuter, 2015; Hackethal, Haliassos, and Jappelli, 2012; Hoechle et al., 2017; Mullainathan, Noeth, and Schoar, 2012; Foerster et al., 2017). Egan, Matvos, and Seru (2017) show that a significant percentage of advisors have disputes with their clients and suggest that certain firms "specialize" in misconduct and cater to unsophisticated consumers. Several papers examine other factors associated with dispute rates. Dimmock, Gerken, and Graham (2017) show that advisors learn

from their peers and that misconduct is contagious among co-workers. Charoenwong, Kwan, and Umar (2017) show that advisors' behavior responds to regulator identity. In our paper, we document that advisors' treatment of clients is related to the internal incentives created by the assignment of property rights to the client relationship.

We also contribute to the literature on property rights, ownership, and boundaries of the firm. Assignment of ownership can encourage asset-specific human capital investments by reducing the threat of holdup (Williamson, 1979; Grossman and Hart, 1986; Hart and Moore, 1990). Simester and Wernerfelt (2005) use a data set describing ownership of productive assets in the carpentry trade to evaluate several factors influencing the allocation of asset ownership between an employer and its employees. They find that employees are generally more careful with their own tools (the productive asset) than with the tools owned by the firm. Massa, Reuter, and Zitzewitz (2010) show that mutual fund families weigh the benefits of naming managers (which, they argue, gives the manager "ownership" of the fund's record) against the cost associated with the manager's increased future bargaining power (in this context, moving to a hedge fund). In the context of the trucking industry, Baker and Hubbard (2004) exploit the introduction of onboard computers as a shock to non-contractable driver care (by making care observable) to examine its effect on ownership. In our paper, we observe a shock to property rights and examine how employees change their investments in general and firm-specific human capital in response.