

REGULATING HOUSEHOLD FINANCIAL ADVICE

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Abstract

This paper reviews economic theory related to investment advice. This theory explains 1) why financial advisors need to be carefully regulated for the benefit of both the investment advice industry and for consumers, 2) why principles-based regulation (e.g., a fiduciary standard) is more efficient than rules-based regulation, 3) why dual regulation of financial professionals providing investment or insurance advice is inefficient and inequitable policy, and 4) why the application of a universal and uniform fiduciary standard will be difficult to implement.

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In an efficient market, consumers will employ a financial professional if doing so is expected to maximize personal welfare. Specifically, consumers pay for financial advice when they believe the advisor knows more than they do about investing or insurance products and that the perceived benefits of hiring a financial professional outweigh the perceived costs. Without an informational imbalance between a consumer and an advisor, no motivation exists to pay for expert advice. However, an information imbalance will not yield an economically efficient market outcome without adequate regulation to guide the behavior of financial professionals.

This paper reviews economic theory related to investment advice. This theory explains 1) why financial advisors need to be carefully regulated for the benefit of both the investment advice industry and for consumers, 2) why principles-based regulation (e.g., a fiduciary standard) is more efficient than rules-based regulation, 3) why dual regulation of financial professionals providing investment or insurance advice is inefficient and inequitable policy, and 4) why the application of a universal and uniform fiduciary standard will be difficult to implement.

For the sake of clarity, the terms *financial professional*, *financial advisor*, and simply *advisor* refer to individuals who provide retail consumers personalized investment and/or insurance advice. In this sense, a financial professional may be an investment advisor, a broker-dealer, and/or an insurance agent. Similarly, the term *financial advice* or simply *advice* broadly refers to the personalized advice that these professionals provide.

1. The Economics of Financial Advice

An inability to accurately detect quality prior to or even after a purchase distinguishes professional advice from other consumer goods or services. As with other credence goods, consumers have a difficult time assessing the quality of financial advice, even long after the advice is given (Nayyar & Templeton, 1994). A consumer who is unable to accurately assess quality must rely on imperfect cues from the professional to estimate whether the professional is providing good advice. This delegation of decision making to a financial advisor leads to predictable consequences that vary in the degree of potential loss to the consumer. The degree of potential loss depends on elements of the relationship between the consumer and the financial advisor.

A principal-agent relationship exists when a consumer (i.e., a principal) delegates investment or insurance decision making to a financial advisor (i.e., an agent) (Jensen & Meckling, 1976). If the consumer hires an omniscient and selfless financial advisor who cares only for the welfare of the consumer, the outcome will be a set of recommendations that maximizes the welfare of the consumer. Financial advisors, however, are self-interested and have their own set of preferences. Acting as agents of the consumer, financial advisors seek to maximize their own welfare by generating the most revenue or perquisites for a given level of input, typically time. As a result, the recommendations from a self-serving advisor may seek to extract excess rents from the consumer. Consumers are largely unable to assess the quality of an advisor's recommendation, making them vulnerable to the self-serving behavior of the agent.

The difference between an outcome that maximizes a consumer's welfare and one that maximizes an advisor's welfare represents the agency costs of hiring an agent.

It is impractical and economically inefficient to expect no agency costs (i.e., consumer losses) from the delegation of decision making to a financial advisor. However, these losses can be minimized through effective oversight (i.e., monitoring), contracting, and advisor-initiated restrictions on self-serving behavior (i.e., bonding). Regulation that decreases the monitoring costs of consumers or increases the bonding costs of financial advisors, especially when acting imprudently, results in an increase in consumer welfare. Since consumers do not have the knowledge to provide sufficient oversight, they may collectively fund a government entity (e.g., the Securities and Exchange Commission (SEC)) that employs knowledgeable inspectors to assess advisor quality and impose penalties when advice is excessively self-serving. The effectiveness of this oversight is subject to the knowledge of the inspectors, the number of inspectors relative to number of advisors being overseen, and the authority granted to the regulator. Naturally, adequate funding of such a regulator is also required for effective oversight.

Contracts that reduce agency costs may include paying for advice through fees rather than commissions in order to better maintain incentives that align the interests of the consumer and advisor. Self-interested, commission-based financial advisors are more likely to encourage frequent trading within an investment portfolio. Mullainathan, Nöth, and Schoar (2010) find that commission-based advisors tend to encourage return-chasing behavior and actively managed investments, even when new clients have well diversified, low-cost portfolios. Anagol, Cole, and Sarker (2012) find that a majority of commission-based advisors recommend products that generate high commissions when a lower-cost product is more suitable for the consumer. They also find that commission-based advisors will avoid products that require disclosing costly commissions and will even recommend products with higher commissions if they do not require disclosing the commission.

The appeal to some advisors of commission-based compensation lies in its lack of saliency. Recent studies provide evidence that charging consumers via a more opaque pricing model (i.e., a pricing model where the consumer is less readily able to calculate how much they are paying for the product or service) leads to lower price sensitivity (see, e.g., Cabral & Hoxby, 2009).

In an environment with opaque commissions and no disclosure requirements, self-serving financial advisors are likely to drive more selfless advisors out of the market. Consumers may assume that the price they pay for commission-based advice is less than

what they actually pay. As a result, a consumer may seek advice from an advisor with shrouded prices instead of seeking the services of a more reputable advisor whose prices are more straightforward but higher than the consumer is willing to pay. In the end, the lower-quality advisor obtains the business of the consumer.

Financial advisors incur bonding costs to provide assurance that they will act in the best interest of the client. Examples include voluntary exposure to torts or adherence to the rules of a self-regulatory organization (SRO) (e.g., Financial Industry Regulatory Authority (FINRA)) or a certifying organization (e.g., Certified Financial Planner Board of Standards, Inc. (CFP Board)). For example, financial professionals who attain and maintain the Certified Financial Planner™ certification agree to abide by CFP Board's *Code of Ethics* and *Rules of Conduct*. CFP Board promotes this voluntary bonding mechanism in their marketing material:

"The Rules of Conduct require CFP® professionals to put your interests ahead of their own at all times and to provide their financial planning services as a 'fiduciary'—acting in the best interest of their financial planning clients."

(CFP Board, 2012, p.12)

By obtaining a designation that voluntarily restricts an advisor's ability to extract rents from a client, an agent provides a signal of reduced agency costs in order to increase demand for their services.

Differences in regulation affect the incentives of advisors by shifting the monitoring and bonding costs of providing self-serving advice. Traditionally, expert advice professions such as law and medicine assert a legal standard of care similar to a fiduciary relationship. This standard of professional conduct between principals and agents exists to provide adequate incentive to minimize agency costs to consumers. The threat of litigation serves as a bonding mechanism (i.e., the assumption of legal liability) and can mitigate otherwise high monitoring costs of governmental or SRO oversight. If the financial repercussions of offering self-serving advice are sufficiently large, advisors who make low-quality recommendations will suffer while higher-quality advisors stay in business. In the absence of proper disincentives, the advisors who are most successful will be those who make recommendations that maximize their own revenue rather than the welfare of the client. Because consumers cannot adequately identify the quality of an advisor, less financial advice is demanded at a given price, and the average quality of advice within the profession declines because there is little incentive to make informed recommendations that are in best interest of the client (Akerlof, 1970). A lack of proper incentives results in a significant loss to both consumers and quality financial advisors while lower-quality advisors benefit from the information asymmetry.

2. Rules under Which Advisors Must Operate

Financial advisors are subject to different regulation, depending on the activities performed (Macey, 2002). Two main types of financial advice regulation exist: rules-based regulation and principles-based regulation. Under a rules-based system regulators attempt to specify acceptable and unacceptable behavior by generating a long list of rules under which advisors must operate. Conversely, the focus of principles-based regulation is to provide a general guideline for behavior against which advisors can judge their actions. The common rules-based approach to financial advice is embodied in the suitability standard, where a particular financial product must be suitable for a client. The principles-based approach to financial advice is illustrated by the fiduciary standard, where advisors must act in the best interest of the client, seeking the interests of the client first (i.e., above the interests of the advisor). The suitability standard is generally viewed as an inferior standard because many products may be suitable but not necessarily in the best interest of the client.

Some financial advisors are regulated as investment advisors by the SEC or a state securities regulator and are subject to a fiduciary standard of care. Others are regulated by FINRA, which emphasizes a standard of suitability and abidance to established rules of actions. Having two regulatory regimes can be confusing for consumers. Compounding the problem, many investment advisors are also registered representatives of a broker-dealer, making them subject to dual regulation under both regimes. Consumers of dually regulated advisors may not realize that the fiduciary standard of care to act in their best interest only applies when the advisor is acting as an investment advisor. In other words, some of the services performed by a dually registered advisor may not be required to be in the best interest of the client.

Other financial advisors may be registered with their states as insurance agents and are subject to state insurance regulators. Some of these advisors may also be dually registered as broker-dealers. State regulators of accountants and attorneys typically allowed these professionals to provide financial advice as long as any advice is "solely incidental" to the practice of their profession. If accountants or attorneys hold themselves out as financial advisors, they are also subject to applicable state and federal regulation, depending on the type of advice they are providing.

The lack of a single regulatory regime for financial advisors creates confusion for consumers, who typically do not recognize financial advice as a distinct profession (Regulation Task Force, 2006). The uncertainty in the quality of financial advice is complicated by financial professionals who use

similar job titles (e.g., financial planner, financial advisor) but operate under different regulatory regimes (Hung et al., 2008). With different bonding mechanisms under each regulatory regime, consumers are provided with varying degrees of protection (i.e., advisors are subject to different levels of repercussions when acting imprudently), which resulting in a variety of qualities of financial advice.

Industry representatives of financial services firms regulated under a rules-based standard of care have lobbied vigorously against the imposition of a fiduciary standard of care to any professional who is advising and selling financial products to consumers (See, e.g., Dow Jones, 2010). This push back against the fiduciary standard suggests that the net revenue under a suitability standard is greater than would be available to these firms under a fiduciary standard. The primary cost savings under a suitability standard is the reduced bonding costs of less liability exposure, due to a regulatory environment that merely limits product recommendations rather than the prohibition of product sales that are not in the best interest of the consumer.

A rules-based standard of care may allow advisors to earn more from providing financial advice than they could earn in the absence of regulation. The existence of a regulatory body that provides oversight to a profession is a signal to consumers that they need not expend resources on costly oversight or contracting in order to reduce the potential for self-serving behavior by the advisor. This increases the consumer's willingness to buy the service and to trust the advisor. Consumers consistently list trust as the most important characteristics of a financial advisor for this reason (Hung et al., 2008). A client who trusts their advisor believes that the advisor is less likely to take advantage of the information asymmetry inherent in an expert-advice relationship. This trust leads to a reduced perception of agency costs which leads to a decrease in the overall cost of hiring an advisor. By signaling to the public that oversight of a rules-based regulator exists, advisors can earn the trust of clients without putting the interests of the client first.

This trust in a regulator reduces the degree of client oversight and provides opportunities for advisors to make recommendations that maximize their own welfare within the boundaries of the regulatory rulebook. Rather than making recommendations in the best interest of the client, the objective of the advisor is to maximize their own welfare subject to the rules prescribed by the regulator. This will lead to strict minimum thresholds of suitability, such as the maximum load on a mutual fund or the variable annuity with the largest commission, that are inevitably adopted by advisors hoping to maximize income within the regulatory constraints. Rather than recommending a mutual fund or ETF that provides the greatest expected return for a given level of risk, advisors will tend to recommend

funds and variable annuities that provide the greatest revenue to themselves without violating the rules of suitability. Advisors who do not recommend these funds may be violating a contractual obligation to act in the interest of their employer, or may be edged out of the market by more profitable advisors.

On the surface, rules-based regulation appears to have the client's interest in mind by requiring advisors to follow a lengthy list of rules designed to protect against imprudent behavior. An alternative view would suggest that the rules-based approach is designed to protect a financial services company from the inappropriate behavior of its advisors. By encouraging a regulator to specify acceptable and unacceptable behavior, firms can limit their liability exposure due to their advisor's behavior, which is especially important when a firm has a considerable number of advisors (and supervisors) to oversee.

Applying a fiduciary standard to all financial professionals who provide personalized financial advice will eliminate many of these conflicts of loyalty between advisors and clients. A fiduciary standard also increases the bonding costs of advisors, which will more closely align the incentives of clients with their advisors. A fiduciary standard also implies that the interests of the client will come first, not just before the interests of the advisor but also before the interests of the advisor's firm. A broader application of the fiduciary standard will also increase the risk from selling inappropriate products that are primarily a source of revenue for the financial services industry by forcing advisors to subject themselves to the threat of litigation. Increasing the risk associated with promoting self-serving yet sub-par recommendations will result in a net transfer from advisors who are able to extract excess rents from the advisor-client informational imbalance to consumers and to advisors whose recommendations are more appropriate and in the best interest of the client.

To be most effective, a fiduciary standard needs to be universal and uniform. A universal fiduciary standard implies that the standard applies to advisors providing personalized financial advice regardless of regulatory regime. Having financial advisors who fall outside the financial standard will prolong the confusion that currently exists by having multiple standards of care. A uniform fiduciary standard implies that the same standard applies regardless of the regime. Having multiple definitions of a fiduciary only creates additional confusion and opportunities to extract rent from less sophisticated consumers. Consumers will benefit most from a universal and uniform fiduciary standard because only then can they be sure that the financial advice they receive will be in their best interest.

The imposition of a universal and uniform fiduciary standard will also reduce the perception of potential agency costs by consumers who would otherwise be unwilling to pay for financial advice. This reduction in agency costs to consumers will

likely increase demand in the broader overall market for financial advice, leading to an increase in welfare to currently underserved consumers and to the new fiduciary advisors who would serve them. The overall increase in consumer welfare from a reduction in agency costs will likely be positive as the inefficiencies from agency costs shrink.

Opponents of the fiduciary standard argue that the supply of advisors will decline because fewer advisors will be willing to offer advice under the fiduciary standard. The basis of this argument is that the fiduciary standard exposes advisors to increased litigation risk, for which they argue advisors must be compensated. However, Finke and Langdon (2012) compare the markets of registered representatives in states that vary in fiduciary common law standards. They find no evidence that stricter fiduciary standards impact the supply of advisors. These results make sense since the increased litigation costs are primarily borne by advisors who make self-serving recommendations. These advisors will largely be unable to bear the increased costs of their self-serving behavior and will need to align their interests with those of their clients, or they will need to stop providing financial advice altogether.

3. Regulation of Financial Advice

Multiple regulators exist within the financial services marketplace with some regulators operating at the federal level (e.g., SEC, FINRA) and other regulators operating at the state level (e.g., insurance industries). This fractured regulatory system complicates the ability to adequately regulate financial advisors who frequently recommend and market multiple types of financial products. The Gramm-Leach-Bliley Act (GLBA) of 1999, allowed for the consolidation of financial firms, which began to blur the traditional boundaries in the industry (Carow & Heron, 2002; Macey, 2002). The passing of the GLBA led to a theoretical shift in regulatory policy, moving towards a functional approach to regulation (Macey, 2002). Rather than overseeing entire firms, regulators are now primarily responsible for specific actions performed within a firm, complicating the regulation of financial advisors who cover a wide spectrum of activities but often on a small scale.

Adding to the problems with the current approach to regulation are the constrained budgets of the federal regulators. In many instances, they simply are not able to provide the intended oversight because they lack proper funding (See, e.g., Gray, 1994; Macey, 2002). For example, part of the reason for the division of federal and state investment advisor regulation, including the recent adjustments resulting from the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), is a lack of federal appropriations for the SEC to adequately perform routine inspections of investment advisors. Without proper funding, effective regulation of the

financial services industry will be difficult. To be beneficial, enforcement of a universal and uniform fiduciary standard could not fall solely on the SEC without a large increase in revenue for the agency.

Another problem with the application of a universal and uniform fiduciary standard to financial advice is that product-based compensation is ubiquitous within the industry and rarely leads to recommendations that are clearly in the best interest of the consumer. Nearly all registered investment advisors (RIAs) charge clients asset-based fees, commonly 1% of assets under management (Dean & Finke, 2011). Most RIAs also have minimum assets under management (AUM) requirements that far exceed the investable assets of most consumers (Helman, Copeland, & VanDerhei, 2010; Dean & Finke, 2011). As a result, many consumers are served by commission-based advisors who are held to a suitability standard. In other words, in the financial marketplace, lower-wealth consumers may be more likely to suffer agency costs from recommendations that are not in their best interest. If commission-based advisors were subject to a fiduciary standard of care, the likelihood would greatly increase that financial advice provided to the average consumer would be in the consumer's best interest.

Despite the fear that fiduciary financial advice would lead advisors to abandon middle-class customers, it has not devastated the market for many other expert advice services that are regulated as fiduciaries. Because a universal and uniform fiduciary standard for financial advice would improve the quality of advice, more middle-class consumers may perceive the potential benefits outweighing the decreased costs, agency and otherwise. Without any changes to the current situation, consumers who are able to afford the investment minimums of investment advisors (currently held to the fiduciary standard) are receiving a service where the provider is held to a stricter standard. Subjecting the financial advisors of the rich to a stricter code of conduct than the less wealthy may be viewed as a regressive consumer policy. A universal and uniform fiduciary standard would decrease this inequitable policy that currently exists.

Conclusion

The market for financial advice has changed dramatically over time, especially since the regulation of securities markets began during the Great Depression. Although the reason for the broker-dealer exclusion from the Investment Adviser's Act of 1940 is largely lost in history, the situation can still be remedied by implementing a universal and uniform fiduciary standard. Under the current regulatory regime in the U.S., even sophisticated consumers are unable to determine when an advisor is held to a fiduciary standard and when they are not. The lack of clarity of professional standards contributes to a

consumer's distrust in financial advisors. Self-serving advisors who benefit from the consumer confusion will oppose the implementation of a standard requiring them to act in the best interest of consumers. However, enacting a universal and uniform fiduciary standard will simplify the market for financial advice and increase demand for quality financial professionals.

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