CLIENTS, COMMISSIONS, AND POTENTIAL CONFLICTS OF INTEREST:
Registered Investment Advisers in the U.S.

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This research is part of Luke Dean's dissertation at Texas Tech University. Special thanks to Mina Bielow and Harold Evensky of Evensky & Katz for their assistance with the Form ADV, and their comments on an earlier draft of this manuscript.
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ABSTRACT

The recent economic crisis has spurred a fresh look at financial services policy issues in the U.S. and abroad. This study examines 7,043 Registered Investment Advisers (RIAs) in the United States in order to examine what type of clients are more likely to hire an advisor with great potential conflicts of interest. Results suggest that potential conflicts of interest like previous ethical violations, charging commissions, and being dually-registered as a broker-dealer are positively associated with lower net worth clients. Wealthier clients appear to be less likely to hire a financial advisor with these potential conflicts of interest. Lower net worth clients need professional advice, but appear to be more likely to hire professionals who have more conflicts of interest. Because of the prevalence of commissions and potential conflicts of interest, especially amongst lower net worth clients, American policy makers may consider eliminating the 'suitability' standard as opposed to eradicating commissions on financial services products as Australia and the U.K. have recently done.

Key words: Registered Investment Adviser, RIA, fiduciary, agency costs, commission, conflict of interest, ethics, broker, dealer, registered rep, Investment Advisers Act of 1940.

Introduction:

Complex nature of personal financial planning compensation

Recently, the Financial Services Authority (FSA) in the United Kingdom banned financial advisers from receiving commissions on retail investment products and volume-based sales beginning in 2013 (see FSA, 2010 for a thorough review of the new regulations and guidelines for implementation). This was done in an effort to tie charges to "the level of service provided" to the consumer as opposed to the "particular provider or product" being recommended by the financial adviser (FSA, 2010). Australia enacted similar legislation which will take effect in July 2012.

Opponents of this legislation argue that doing so will reduce the amount of financial service professionals in the industry and have a negative and disproportionate impact on low net worth consumers who may be less able to afford professional advice or may be less willing to seek out and pay for professional advice if the true cost of the advice becomes more salient.

Compensation conundrum

While virtually all RIA's charge a percentage of assets under management (98.5%), only a small portion of RIA's receive compensation in the form of commissions[1] (12.7%). The prevalence of AUM fees suggests that this is by far the preferred form of compensation for RIA firms. Considering the operational benefits of the expected annual revenue stream and the increasing economies of scale associated with managing more assets, the advantages of this form of compensation to the firm are evident. However, there are a few negative externalities associated with charging clients a percentage of assets under management. In a recent RAND

[1] Dean (2010) paper 2/Chapter 3 indicates that although commissions are charged by only 12.7% of RIA firms with individual clients, they account for 38.6% of all accounts.

research report sponsored by the SEC, RIA's reported not providing service to many investors because the investors could not meet the account minimums (Hung et al., 2008). More than half of the RIA firms responding to the survey indicated a minimum requirement of $1 million in investable assets. A small number of firms were willing to have account minimums between $100,000 - $500,000 and the authors reported typical fee structures of 1.25% for assets under $1 million, 1% for $1M - $5M, .75% for $5M - $10M, and .25% for more than $10M (pg. 73). Therefore, the typical RIA firm charging a percentage of AUM is indicating that it needs a minimum expected income stream of at least $10,000 annually in order to accept a client. According to recent data from the Survey of Consumer Finances, fewer than 22% of American workers have more than $100k in savings and investments, and only 11% have more than $250k (Helman et al., 2010). When the sample is limited to retirees, only 27% report having more than $100k, and 42% report having less than $10k.

Based on these numbers and Hung et al.'s research (2008), it is safe to say that most RIA firms are seeking to provide professional services to approximately 5% of the U.S. working population. And a small number of firms willing to accept clients with as little as $100k in assets would only be willing to provide service to 22% working Americans and 27% of retirees. On the other side of this coin is another problem. Even for the few firms willing to accept clients with $100,000 in investable assets with a 1.25% AUM fee, the minimum annual compensation is expected to be at least $1,250 per year, a cost which may be perceived as being prohibitive for low net worth and moderate net worth households.

In contrast, the authors of the RAND research report also examined broker-dealers who are primarily compensated via commissions and found that more than half of them had *no* account minimums and were willing to assist investors with small sums (pg. 69). Adam Smith

would be quick to point out that it is not necessarily the benevolence of the butcher, brewer, baker, or broker that is accountable for this difference in willingness to serve low net worth clients. The broker-dealers willingness to serve clients without any minimum investment amount suggests that the commissions from the current transaction(s) are sufficient compensation for their services. Even a client with as little as $5,000 to invest may be recommended to purchase a fund[2] with a 5.75% sales commission, and a 12b-1 fee of .75%, generating approximately $287.50 initially and $37.50 annually, depending on the funds' subsequent performance and holding period. If the compensation from the current transaction is not sufficient to justify the broker-dealers' services, then it suggests that the broker-dealer is accounting for any and all potential future transactions with this client and possible referrals from this client into their willingness to provide service. Additionally, the broker-dealers responsibility to the client is complete after the transaction has been made (pg. 12).

Willingness to pay related to salience?

It is possible that low net worth clients are willing to pay a relatively high portion of their investable assets as commissions because the fees associated with the service are very opaque. Shrouded fees and costs are seemingly ubiquitous for American consumers who experience them everywhere from hotels, banks, cell phone plans, grocery stores, rental cars, ink cartridges for printers, and even when attempting to bring luggage on flights. Gabaix and Laibson (2006) categorize shrouded costs into those that are avoidable (parking, room service, internet and phone fees at hotel, text messaging, ATM use) and those that are unavoidable (sales tax).

[2] APIUX was the mutual fund used for this example. Jackson (2008) suggests that when recommending proprietary funds, agents can receive additional bonuses, mark-ups, or underwriting fees from their employer and product providers. Harold Evensky notes that instead of a heavy front-loaded fund like APIUX, it is likely that dually registered broker-dealers would recommend a deferred load fund with a higher 12b-1 fee. (See http://www.sec.gov/answers/mffees.htm#salesloads for more information on how advisers might use sales loads).

Sophisticated consumers can usually benefit by avoiding the expensive add-ons. In the context of financial services, the ongoing relationship between client and firm includes costs that might be somewhat shrouded to the consumer. According to Gabaix and Laibson (2006) when a firm is over-reliant on shrouded fees as broker-dealers are, they are susceptible to competitors "un-shrouding" their expensive shrouded fees and luring away their customers. Hung et al., (2008) present some convincing evidence that RIA firms are doing exactly this, demonstrating that between 2001-2006 the number of RIA firms increased by 37% while at the same time the number of broker-dealers experienced a 9% decline. Additionally, the number of broker-dealers who are dually registered as RIA's increased from 9.5% to 10.6% while the number of RIA's dually registered as broker-dealers declined from 6.9% to 5.1% (pg. 36).

A plethora of research suggests that most Americans are unaware, unwilling, or unable to factor shrouded costs into their consumer behavior. Even highly educated consumers examining simplified disclosure documents do not understand the impact of a mutual fund load (Beshears, Choi, Laibson & Madrian, working paper). An in-store experiment demonstrated that consumers tend to underreact to less salient taxes like sales tax which is applied at checkout (Chetty, Looney, & Kroft, 2009), and electronic toll collection systems where the toll is automatically deducted from a consumers account as they drive through a toll plaza (Finkelstein, 2009). Consumers also appear to be willing to spend significantly more when using more opaque forms of payment like credit cards (Prelec & Simester, 2001; Feinberg, 1986) and income tax refunds (Souleles, 1999). Therefore, it is plausible and even likely that the average consumer might be less willing to seek professional financial advice if the fees associated with the advice were more salient or transparent to the consumer. Perhaps this is why Hung et al (2008) discovered that broker-dealers tend to make the required compensation disclosures at the point of sale (which

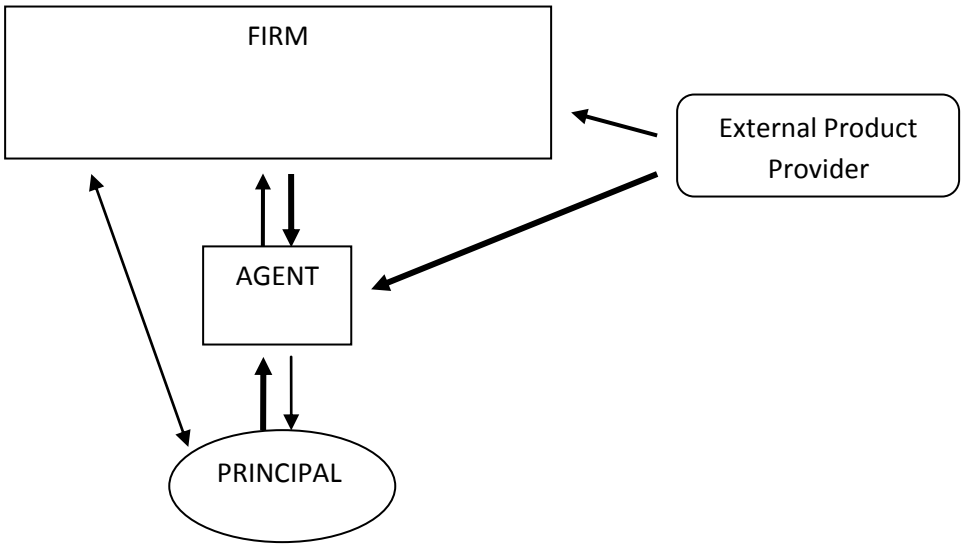
effectively shrouds the cost until the end of the client-agent interaction), as opposed to doing so at the beginning of their first meeting with the client when most RIA's make their required compensation disclosures.

Compensation arrangements

There are effectively 3 parties involved when a principal seeks professional advice from an agent. The principal, the agent, and the agents firm. This creates what Jackson (2008) refers to as the "trilateral dilemma". The agent has a duty to both the principal and the firm. The firm has a duty to both the principal and the agent. And the principal expects that both the agent and the firm are working in conjunction to maximize their profit. Compensation arrangements impact the weight given to each of these relationships from the agents' perspective. From the firms perspective, a straight commission compensation arrangement creates incentive for their agents to be consistently productive for the firm (Kurland, 1991) and allows them to more liberally hire new employees and professionals because the employees only get paid when they produce for the firm. For the client-agent relationship, a flat fee, hourly fee, or percentage of AUM creates incentive for the agent to provide higher quality advice. Information asymmetries between clients and agents creates its own incentive for experts to extract rents from clients who are unable to determine a low quality solution from a high quality solution (Dulleck & Kerschramer, 2006). Shrouded costs like 12b-1 fees, dealer concessions, and commissions tend to be criticized because consumers don't appreciate that they ultimately bear the costs of the payments they make to the agent, they place a large degree of trust in their professional advisers, and they don't scrutinize the fine print, pricing, and disclosures very carefully (Jackson, 2008). And even if consumers did scrutinize the statements, the aforementioned evidence creates doubts

regarding their abilities to distinguish the quality of advice they received (see Dulleck & Kerschramer, 2006; Beshears, Choi, Laibson & Madrian, working paper; and Kurland, 1991).

Figure 1. Visual representation of the potential conflicts of interest unintentionally created by compensation arrangements in financial services.



Registered investment advisers with high net worth clients tend to prefer compensation schemes that will generate a long-term stream of income like wrap fees or a percentage of assets under management. Advisers who are solely reliant on these types of fees will be less likely to accept clients with low net worth because the amount of effort to advise the client and handle the compliance and regulatory requirements of assisting the client are not justified by the pecuniary benefits for doing so. Other compensation schemes like commissions, hourly charges, and fixed fees are more amenable to assisting low net worth clients. If a client only has $10,000 in investable assets, it is unlikely that an adviser will spend the time and resources to develop a comprehensive financial plan and provide regular monitoring of the clients situation when a recurring fee of one percent of the assets under management would net the adviser approximately $100 annually in compensation. However, an adviser who charges commissions would be more

willing to assist a client with $10,000 to invest because they could conceivably receive up to 8.5% commission via the front load, up to 1% annually via the 12b-1 fee, and might also receive some additional remuneration from their employer in the form of bonuses, dealer concessions, or vacations, especially if the fund sold is a proprietary product where the firm can generate extra revenue from underwriting fees and captive management fees (Kurland, 1991).

While most of the compensation in this example will likely be a one-time occurrence, the fees and bonuses generated are sufficient for the adviser to engage the client and provide recommendations. Hung et al (2008) interviewed a sample of RIA firms and reports that the minimum annual fee that *any* RIA firm was willing to accept was between $500 - $5,000 for advisory accounts (pg. 73). For low net worth clients, these fees might be perceived as prohibitive, especially if the costs of the advice become more salient.

Compensation for advice and conflicts of interest

In general, a principal who hires an agent expects that the agent will act in the best interest of the principal. However, the financial services industry utilizes a great deal of complex financial instruments with a wide variety of incentives (Burton, 1994) including some which create a conflict of interest for the agents' when recommending them. Jensen and Meckling (1994) argue that it is impossible to remove incentives entirely from any individual or organization, and therefore the focus should be placed more squarely on deciding what types of incentives to encourage and what types of incentives to discourage. All else being equal, it is possible that a financial adviser working in a commission-only environment will recommend different financial instruments or products than he or she would if they were working in a fee-based environment and vice versa. For example, advisers who receive commissions are more likely to recommend proprietary products and have no pecuniary incentive to recommend

Exchange Traded Funds or mutual funds without loads or 12b-1 fees. Advisers who receive compensation as a percentage of assets under management tend to have a larger universe of financial products to select from. Because they are compensated annually as a percentage of AUM, they have no pecuniary incentive to recommend funds with loads or 12b-1 fees and they have no pecuniary incentive to recommend paying down debt or purchasing products that would diminish the amount of assets under management (i.e., insurance, immediate annuities[3], and property). Ceteris paribus, it is not surprising that a financial adviser working for an hourly rate or a flat fee will recommend different financial instruments or products than he or she would if they were working under a different compensation arrangement (see Robinson, 2007 for a review of the conflicts of interest associated with various fee structures in financial planning).

Analyses in this manuscript will examine whether lower net worth clients are more likely to be charged commissions by registered financial advisers in the United States today. While the present dataset does not include information on the exact amounts of compensation each advisor charges clients, the information on compensation structure is useful for understanding some of the potential alignments and misalignments of interests (Golec, 1992) within the principal-agent relationship that financial services professionals (agents) face when determining how to charge their clients (principals) for their services (Record & Tynam, 1987). This information is also useful from the perspective of the principal when selecting an agent (or agents) to assist in developing an optimal and efficient investment portfolio and/or financial plan. It is hypothesized that RIA's who charge commissions will have more low net worth clients and less high net worth clients. It is also hypothesized that firms who have high net worth clients will be more likely to charge a percentage of assets under management.

[3] RIA's receiving AUM fees can receive management fees on variable annuities, but not immediate or payout annuities.

Lower net worth clients and agency costs

The recent recession has provided the necessary impetus for many consumers to seek professional assistance in managing their personal finances and investments. Other recent events have underlined the importance of hiring an agent who places the interests of the client above their own. When clients enter the marketplace for professional financial advice, they lack basic knowledge about the differences between financial services professionals and make almost no effort to learn or distinguish amongst financial service products and providers (Bucks, Kennickell, Mach, & Moore, 2009) which results in them paying more for professional advice, either directly via compensation or indirectly via residual losses over time.

A number of studies have demonstrated that the poor tend to pay more for items than the rich (Caplovitz, 1967). Examples include payday lenders, overdraft fees, regressive sales taxes, credit card rates, credit card fees, subprime loans, tax return loans, and even groceries (Chung & Myers, 1999; Finke, Churn, & Fox, 1997). Lower income and lower net worth households have less financial education (Brobeck, 2002; Bernheim, 1998), less access to and awareness of financial and community institutions (Avery, Bostic, Caler, & Conner, 1997), and are more likely to be susceptible to predatory financial practices (Rhine et al., 2001).

Lower net worth clients tend to be less financially sophisticated (Hung, et al., 2008), are more vulnerable to predatory practices (Brobeck, 2002) and are more prone to discriminatory financial practices (Weller, 2009). Hung et al. (2008) demonstrate that investment advice is no different. Generally, RIA's only work with high net worth households, but some RIA's and broker-dealers are willing to work with lower net worth clients when they can charge them more opaque fees with higher rates. Increasing economies of scale make it rational to charge wealthy

clients less, but it still remains that clients with less wealth must pay more (as a percentage) for professional advice.

While it is possible for individuals to engage in portfolio optimization on their own behalf and thus eliminate the need for hiring and compensating a professional, this approach requires significant initial investment of time and human capital (Becker, 1964) and subsequent amounts of continuous investments in time and human capital that prevent otherwise capable individuals from doing so.

Some individuals may have higher opportunity costs or may do not derive utility from the requisite investments in time and human capital necessary—therefore, they may rationally have a lower threshold at which they prefer to hire an agent to optimize their portfolio for them. While hiring an agent provides benefits to principals by allowing them to delegate the duties of optimizing the household portfolio from a comprehensive planning approach to a professional (or professionals), there are a number of direct and indirect costs experienced by principals when hiring agents. The direct costs include pecuniary compensation like fees, commissions, or retainers paid to the professional. The indirect costs include search costs, monitoring costs, non-pecuniary compensation, and residual loss incurred by the principal (Jackling & Sullivan, 2007; Jensen & Meckling, 1976).

Jensen and Meckling (1976) in their seminal work define ‘agency costs’ as the sum of (1) the monitoring expenditures of the principal, (2) the bonding costs of the agent, and (3) the residual loss. Monitoring expenditures are those a principal experiences while scrutinizing the actions and advice of the agent, bonding costs are efforts taken by the agent to demonstrate competence and aligned interests with the principal, residual loss is defined as “the dollar equivalent of the reduction in welfare experienced by the principal due to… the divergence

between the agent's decisions and those decisions which would maximize the welfare of the principal" (pg. 308).

$$Agency\ costs = \sum \left(M_{Principal} + B_{Agent} + Residual\ loss \right)$$

The degree to which agents behavior reflects the best interests of the principal that hired them is influenced by incentives. Financial advisers must simultaneously consider the interests of the principals, the firms that hired them, external product providers, and their own self-interest (Jackson, 2008). Because all parties in the transaction are believed to be utility maximizers, it is expected that agents will not always act in the best interests of the principal (Jensen & Meckling, 1976). The existence of information asymmetries between principal and agent makes it more difficult for the principal to effectively monitor the actions of the agent, allowing unscrupulous agents to maximize their own interest at the expense of the principal. While the authors acknowledge that there is no way to eliminate conflicts of interest, they state that principals can limit divergences from their own self-interest by establishing appropriate incentives for the agent and by monitoring the agent to limit deviant activities. Policy makers can also place constraints on aberrant activities of the unscrupulous.

Despite the inherent direct and indirect costs, a large number of American consumers continue to hire agents to provide financial advice and financial planning services. Rational households and individuals will choose to hire a professional financial adviser to optimize their portfolio as long as the expected benefit is greater than the direct and indirect costs of hiring the agent (see Finke, Huston, & Waller, 2009). However, as the costs rise for hiring an agent, we would expect to see fewer clients willing to absorb those costs and rational consumers would likely seek substitutes.

The purpose of this study is to examine if U.S. consumers avoid RIA firms with higher agency costs and potential conflicts of interest. Based on agency theory, we expect utility maximizing principals to avoid firms with higher monitoring costs. Therefore, we expect that firms with higher agency costs will have fewer clients, smaller account sizes, and a smaller proportion of high net worth clients (who Hung et al. 2008 identify as being more financially sophisticated).

Agency costs associated with RIA firms in the U.S.

Principals who hire agents must monitor the activities of the agent in order to minimize residual losses and ensure that the agent is acting in the principals' best interest. The agents may incur some bonding costs through contracting or professional certification like the CFP®, CFA® or other professional certifications or memberships in professional organizations (FPA, NAPFA, etc.) that signal a certain level of competence, commitment, or code of ethics to consumers. The current dataset does not identify the professional certifications or organizations that RIA firms belong to, but it does identify a number of other factors that would create increased monitoring costs for principals.

Ethical Violations

Form ADV incorporates 24 questions addressing whether the firm or its advisory affiliates (employees, partners, directors, or persons controlling or controlled by the firm) have been arrested, convicted, or charged of any previous wrongdoing by the SEC, courts, or other federal regulatory agencies in the last 10 years. The answers to the 24 items were combined to create a simple dummy variable where 1 = yes they have had a previous ethical violation and 0 = no, they have not had a previous ethical violation. While most firms (n = 6,474; 87.5%) report no previous ethical violations, some firms did report at least 1 previous ethical violation (12.5%)

and would theoretically require more monitoring then firms that have not had to report a previous ethical violation. The most ethical violations reported by any firm were 21 out of 24 possible violations.

Dual-registration as a broker dealer

All RIAs are regulated under the Investment Advisers Act of 1940, which holds them to a fiduciary standard requiring them to place the interests of the *client* above their own and to disclose any potential conflicts of interest. Broker-dealers are generally regulated under separate legislation known as the Securities and Exchange Act of 1934 which allows them to place the interest of their *employer* above the interest of their clients, and only requires them to provide advice that is "suitable" for their clients instead of optimal. A number of studies have demonstrated that American consumers are unaware of the different regulations and different standards of care (Hung et al, 2008; FPA & TD Ameritrade references).

While all RIAs are held to a fiduciary standard of care under the Investment Advisers Act of 1940, and broker-dealers are only required to do what is "suitable" under the 1934 Act – there is a small subset of broker-dealers who are dually registered under both sets of regulation as long as they make disclosures to their clients. RIAs who are dually registered (17.7%) constitute a sub-group of financial advisers who would require additional monitoring costs due to the fact that principals employing dual-registered agents will need to identify and discern which actions of their agent are that of a fiduciary acting in the clients best interest, regulated under the Investment Advisers Act of 1940; and which actions are that of an adviser who only needs to recommend what is 'suitable' to their clients and is operating under the SEC Act of 1934. Research indicates that most American consumers are ignorant of the difference between the two

standards of care, and expect all financial service professionals to act in their best interests (Hung, et al., 2008; TD Ameritrade, 2009; Opiela, 2007).

Employees who are dually-registered

Similar to dual registration, except instead of the firm being dually registered as a broker-dealer, the firm reports having employees who are dually-registered (37%). Therefore, the individual client needs to incur some monitoring costs to determine if their agent at the firm is dually-registered and if so – when their agent is acting as a fiduciary under the 1940 legislation or when they are giving advice that is 'suitable' under the 1934 SEC Act.

Complex nature of personal financial planning advice

Due to the recent economic crisis, a growing number of individuals are seeking professional assistance with managing their wealth. Individuals who already had professional assistance are re-evaluating more closely the competence, credentials, and costs associated with their adviser. Previous literature has suggested there is a need for a comprehensive, portfolio-based approach to the entire family's portfolio as a whole (Black, Ciccotello, & Skipper, 2002). Therefore, the household must strive to maintain an efficient (Markowitz, 1952) portfolio evaluating financial assets, real assets (Delaney & Reichenstein, 1996), human capital (Becker, 1964), government benefits (Fraser, Jennings, & King, 2000), private insurance, and inheritance (Kotlikoff, 1988). The already complex analysis of the household portfolio becomes even more difficult to manage when you take into consideration the dynamic nature of the underlying assets and the even more dynamic nature of the market and the personal and political contexts which have meaningful impacts on the portfolio on a consistent basis.

An individual that understands a variety of financial products and services in isolation is still likely to be overwhelmed when facing the challenge of understanding them in combination

(Black, Ciccotello, & Skipper, 2002) and this complexity is exacerbated when previous portfolio assumptions become obsolete with subsequent changes in tax laws or family context. Income tax, estate tax, and family dynamics change on a continuous basis.

While hiring an agent allows principals to delegate the duties of optimizing the household portfolio from a comprehensive planning approach to a professional (or professionals), there are still costs in terms of compensation, monitoring, and search costs that are required of the principal (Jackling & Sullivan, 2007).

The complex nature of financial planning and portfolio management make professional assistance valuable and beneficial to consumers. However, based on previous surveys and studies it appears that U.S. consumers are ignorant of differences in regulations, disclosures, and credentials being utilized by professionals in the financial services industry. Although there is little argument that professional financial advice would benefit consumers (Black, Ciccotello, & Skipper, 2002), the individual households still face a staggering amount of alternative professionals in the industry and when faced with these alternatives, all individuals will rationally select the option that makes them better off as they see it (Jensen and Meckling, 1994).

Due to the complex nature of financial advice and evaluating the providers of that advice, it is hypothesized that firms with a greater proportion of high net worth clients will be less likely to hire RIA firms with greater potential conflicts of interest. Conversely, it is hypothesized that lower net worth clients will be more likely to hire RIA firms with greater potential conflicts of interest like previous ethical violations, charging commissions, and dual registration as a broker-dealer.

Data:

This study examines all RIA's with individual clients and at least $25 million in assets under management as of July 2008 (N = 7,403). As of July 2008, there were 11,226 investment advisers officially registered with the SEC. Firms reporting less than $25 million in assets under management were eliminated from the dataset, leaving 10,112 firms. A number of firms reported that they had no individual clients and were removed from the sample, leaving 7,403 firms in the sample for the current study.

An investment adviser is a person or firm that gets paid to provide investment advice to clients (SEC, 2009). Individuals or firms that fit the definition of investment adviser must register with the SEC or the state securities agency where they have their principal place of business and comply with regulations designed to protect investors under the Investment Advisers Act of 1940 (Barbash & Massari, 2008; Schubert, 2005). Generally, advisers who have less than $25 million in assets under management must register with the state securities agency, and advisers with over $30 million under management must register with the SEC (Blake, 2008). Firms that manage between $25-$30 million in assets have some flexibility to choose which regime they would prefer to register with.

Firms that register with the SEC are required to fill out a "Form ADV" at least annually, and are required to update their ADV information whenever they experience a substantive change in their firm. The Form ADV has two parts: Part 1 has information about the adviser's business and whether they have had previous problems with regulators or clients. This information is publicly available to those who request them via the individual advisers, via the SEC website, and also by visiting the public reference room at the SEC's headquarters in Washington, DC. Morningstar® Direct also provides this information, although their data appears to lag the FINRA version of the data by at least several months.

While all of the RIA's in this sample are held to a fiduciary standard of care, and regulated under the Investment Advisers Act of 1940 – approximately seventeen percent[4] of the firms in the current sample are dually-registered as an RIA firm and as a brokerage firm and can alternate operating under both standards of care with the same clients.

Although the information in the current dataset is publicly available in a number of formats, the present studies are the first designed for academic journals to prepare an overview and analysis of all RIA's in the United States to date.

Purpose of Study

This study examines the population of all U.S. RIA's with individual clients registered with the SEC as of July 2008 to determine which clients are more likely to receive financial advice from an advisor with greater potential conflicts of interest.

Results:

The firms in the sample reported having a median average of approximately $115 million dollars in assets under management and approximately 231 accounts per firm (see Table 1).

Table 1. Assets under management by decile and # of accounts in RIA firms.

	Assets Under Management	Median # of accounts
Min	$25M	1
1st decile	$25 - $35.6M	91.5
2nd decile	$35.6 - $47.4M	125.0
3rd decile	$47.4 - $62.3M	160.0
4th decile	$62.3 - $83.3M	191.5
5th decile	$83.3 - $115M	220.0
6th decile	$115 - $168M	278.0
7th decile	$168 - $269.2M	349.5
8th decile	$269.2M - $511.9M	464.0
9th decile	$511.9M - $1.414B	588.5
10th decile	$1.414B+	1,029.0

[4] While dually registered firms comprise 17.7 % of RIA firms with individual clients, they account for 45.1% of all accounts at RIA firms.

Max	$759,690,000,000	2,539,893
Median	$115,000,000	231
Mean	$2,128,520,110	2,354

In order to determine the average account size at each RIA firm, the total assets under management was divided by the number of accounts reported by each firm.

$$Average\ account\ size\ = \frac{Total\ Assets\ Under\ Management}{\#\ of\ accounts}$$

To compare firms by average account size, this variable was categorized into deciles (see Table 2.)

Table 2. Average account size by decile.

	Average Account Size	Median # of accounts
1st decile	< $148,737	575.0
2nd decile	$148,737 – 218,742	368.5
3rd decile	$218,742 – 292,601	344.0
4th decile	$292,601 – 396,425	280.0
5th decile	$396,425 – 541,673	214.0
6th decile	$541,673 – 779,221	185.5
7th decile	$779,221 -- 1,171,259	150.0
8th decile	$1,171,259 – 2,083,535	116.0
9th decile	$2,083,535-- 6,259,705	91.0
10th decile	> $6,259,705	40.0
Max	$14,402,491,336.50	2,539,893
Median	$541,673.48	231
Mean	$10,853,630.71	2,354

Compensation type

Almost all of the investment advisers charge their clients based on a percentage of assets under management (n = 7,294 [98.5%]), and most receive compensation in multiple forms (n = 5,,743 [77.6%]). Approximately 12.7% receive commissions (n = 943) and 21.6% (n = 1,599) report receiving only a percentage of assets under management and no other forms of compensation. This group will be referred to as the AUMonly group. Figure 2 depicts the

potential conflicts of interest examined in this study and demonstrates how they are associated with average account size deciles (see Figure 2).

Figure 2. The percentage of RIA firms with specific agency costs by account size decile.

Fee type (%)	1st	2nd	3rd	4th	5th	6th	7th	8th	9th	10th
AUMonly (21.6%)	15.3	15.7	16.5	20.5	22.3	25.0	29.3	27.8	26.2	17.8
Commission (12.7%)	23.9	18.5	20.5	16.5	12.3	9.5	8.9	8.1	5.8	3.4
Ethical violations (12.5%)	19.5	18.5	15.7	12.2	9.3	8.6	8.4	9.6	9.9	13.9
Dual Registered as Broker-dealer (17.7%)	31.6	26.1	27.9	21.6	18.1	15.1	13.4	9.3	7.7	5.7
Employees are Registered Reps of BD (37.0%)	57.0	47.7	47.6	42.7	34.4	31.2	26.5	24.3	25.4	32.8

Note: The SEC required hedge funds to register as RIA's (see Hung et al., 2008). Hedge funds generally have ultra-high account minimums and therefore the 10th decile of RIA firms by account size tends to produce slightly irregular responses when compared to more traditional RIA firms.

Figure 2 indicates that for RIA firms with the lowest average account sizes, commissions is charged by almost one-fourth of the firms whereas less than 4% of the firms with the highest average account sizes charge commissions. Therefore, the number of RIA firms charging commissions in the lowest account size decile is more than 7 times higher than the number of RIA firms charging commissions in the highest decile. As expected, RIA firms that have ethical violations, dual registration, and employees that are dually registered are positively associated with lower net worth clients and negatively associated with the higher net worth decile

It is interesting to note that commissions (which are only charged by 12.7% of RIA firms) are more prevalent than AUMonly in the three lowest deciles, but AUMonly becomes far more prevalent as the account size deciles increase. There is almost a perfect negative monotonic relationship between the percentage of RIA firms that charge commissions and higher account

sizes. The opposite effect is apparent when examining RIA firms that charge AUMonly. In general, Figure 2 appears to indicate that commissions, ethical violations, and dual registration are more common for smaller account sizes whereas AUMonly are more common for larger account sizes.

Although Figure 2 visually demonstrates that lower net worth clients are more likely to hire RIA firms with greater potential conflicts of interest – in order to test whether those differences are statistically significant, a chi-square analysis was conducted. The lower deciles represent smaller average account sizes or moderate net worth clients, and the larger deciles represent clients with increasingly more net worth or investable assets as measured by the average assets per account at each RIA firm. Table 3 presents the results of this chi-square analysis and indicates which conflicts of interest are significantly more or less prevalent than expected according to the average account size per firm.

Table 3. Type of potential conflict of interest by account size decile (% of firms that charge this fee).

Average Account Size Decile	AUM only (21.6%)	Commissions (12.7%)	Ethical Problems (12.5%)	Dual Registered as Broker/Dealer (17.7%)	Employees Reg Rep of Broker/Dealer (37.0%)
1st	-	+	+	+	+
2nd	-	+	+	+	+
3rd	-	+	+	+	+
4th		+		+	+
5th			-		
6th	+	-	-		-
7th	+	-	-	-	-
8th	+	-	-	-	-
9th	+	-	-	-	-
10th	-	-		-	-

Note: The "+" sign indicates that according to a Chi-square analysis, significantly more firms than expected within this decile receive this form of compensation. A "-" sign indicates that a significantly lower number of firms than expected within this decile receive this form of compensation.

Based on the chi-square analysis, it is safe to say that as we expected – commissions, dual registration, and ethical violations are significantly more prevalent in RIA firms with smaller account sizes whereas AUMonly fees are significantly more prevalent in RIA firms with larger account sizes.

Are some forms of compensation associated with having more high/low net worth clients?

The purpose of the present study is to determine if certain types of clients are more likely to hire financial advisers with greater potential conflicts of interest. The results of the chi-square analysis support the hypothesis that commissions, ethical violations, and dual registration are more extant for lower and moderate net worth clients whereas AUMonly fees are more extant for higher net worth clients. The previous analysis uses average account size to make inferences about compensation structures in relation to a clients net worth based on the average account size of the firm. To be certain that these findings are actually associated with clients' net worth, the results from the previous analysis are cross-checked with a variable in the dataset where the RIA firms report what percentage of their clients are "high net worth individuals" and what percentage of their clients are "individuals, other than high net worth individuals". The SEC instructions indicate that individuals having more than $750,000 in savings and investable assets are to be considered a high net worth client. For the purposes of the analysis, firms that reported more than 50% of their clients being 'high net worth individuals' were considered to be firms with primarily high net worth clients. Firms that reported more than 50% of their clients as 'individuals other than high net worth' were considered to be firms with primarily moderate net worth clients. Although it is important to note that while we do not know the actual net worth of these clients, it is safe to assume based on the account size deciles in Table 2 that most of these clients are actually 'low to moderate' net worth clients, but to facilitate the summation of

findings will henceforth be referred to as "lower net worth" clients, in lieu of the more cumbersome Form ADV version of 'individuals other than high net worth'.

Table 4 depicts some of the types of compensation listed on the Form ADV. For each form of compensation, a standardized t-test was done to determine if there were significant differences in the dependent variables (average account size, proportion of high net worth clients, and proportion of low net worth clients) when compared according to type of compensation (see Table 4).

As expected, firms that charge AUMonly report having significantly higher average assets per account, a significantly higher proportion of high net worth clients, and a significantly lower proportion of low net worth clients. The average account size for AUMonly firms was over 76 percent larger than the average account size of firms that charged in ways other than or in addition to a percentage of assets under management.

Also, as hypothesized in the review of literature, we discovered that firms charging commissions report significantly lower average assets per account, significantly lower proportions of high net worth clients, and significantly higher proportions of low net worth clients. The average account size at firms that charge commissions is under $3 million, whereas the average account size at firms that do not charge commissions is over $12 million. To put it differently, firms that do not charge commissions tend to have clients with an average account size that is more than 4 times larger than RIA firms that charge commissions.

Although charging a percentage of AUM is preferable for RIA firms for operational purposes and because of increasing economies of scale—the inherent negative externality of AUM compensation is that low and moderate net worth clients are less likely to be served by these firms. Table 4 demonstrates that commissions have a greater proportion of low net worth

clients, lower proportion of high net worth clients, and smaller average account sizes per firm. Approximately half of RIA firms with primarily low net worth clients report receiving commissions, compared to only 27% of RIA firms with primarily high net worth clients.

Table 4. Form of compensation by average account size and proportion of firms reportedly having primarily High and Low net worth clientele.

	n	Mean	Median	Proportion of firms w/ primarily High Net Worth clients	Proportion of firms w/ primarily Low net worth clients
Total Sample	7,403	$10,853,631	$541,673	41%	35%
AUM only					
Yes	1,602	16,428,363*	695,663	45%***	30%***
No	5,801	9,314,116	502,232	39%	36%
Commission					
Yes	943	2,856,579*	296,098	27%***	49%***
No	6,460	12,021,002	603,284	43%	33%

*p <.05 significance, ** p <.01, *** p < .001

Tables 5-9 present the results of a binary logistic regression analysis done to examine the association between the IV's (proportion of low net worth clients, proportion of high net worth clients, account size), the control variables (Assets Under Management quintiles, and # of employees) and the DV's (commission, AUMonly, ethical violations, dual registration, and employees that are dually registered).

Table 5 indicates that firms with a higher proportion of 'low to moderate' net worth clients are significantly more likely to charge commissions than firms with fewer than 10% of these clients. And as expected, firms with over 50% high net worth clients report being significantly less likely to charge commissions than firms w/ fewer than 10% high net worth clients. Results also indicate that firms with higher account sizes, and firms with higher levels of

AUM are significantly less likely to charge commissions. It is interesting to note that while commissions are negatively associated with larger account size clients and firms with more AUM, they are positively associated with firms that have more employees. This lends some credence to the opponents of banning commissions in England and Australia which claimed doing so would decrease the amount of financial professionals in the field.

Table 5. Binary logistic regression results for Commissions.

COMMISSIONS	β	β	β
Proportion of low net worth clients (vs < 10%)			
11-50% low net worth clients	.313**	-	-
50%+ low net worth clients	.501***	-	-
Proportion of high net worth clients (vs < 10%)			
11-50% high net worth clients	-	-.178	-
50%+ high net worth clients	-	-.580***	-
Account size deciles (vs 1st decile)			
2nd decile	-	-	-.303*
3rd decile	-	-	-..151
4th decile	-	-	-.238
5th decile	-	-	-.499***
6th decile	-	-	-.710***
7th decile	-	-	-.674***
8th decile	-	-	-.686***
9th decile	-	-	-.961***
10th decile	-	-	-.1.530***
Assets under mgmt quintiles (vs 1st quintile)			
2nd AUM quintile	.015	.031	-.037
3rd AUM quintile	-.285*	-.272*	-.227*
4th AUM quintile	-.561***	-.538***	-.420***
5th AUM quintile	-1.188***	-1.209***	-.829***
# of employees	.527***	.514***	.484***
Constant	-2.945***	-2.482***	-1.869***

Note: *= $p < .05$, **= $p < .01$, ***= $p < .001$

Table 6 indicates that there is no significant relation between RIA firms charging AUMonly and the proportion of high or lower net worth clients. The firms with the highest account sizes were significantly less likely to charge AUMonly than firms in the lowest account size decile. And firms that charge AUMonly report having significantly fewer employees.

Table 6. Binary logistic regression results for AUMonly.

AUMonly	β	β	β
Proportion of low net worth clients (vs < 10%)			
11-50% low net worth clients	.124	-	-
50%+ low net worth clients	.081	-	-
Proportion of high net worth clients (vs < 10%)			
11-50% high net worth clients	-	-.130	-
50%+ high net worth clients	-	.003	-
Account size deciles (vs 1st decile)			
2nd decile	-	-	-.010
3rd decile	-	-	.029
4th decile	-	-	.060
5th decile	-	-	.033
6th decile	-	-	.147
7th decile	-	-	.186
8th decile	-	-	-.046
9th decile	-	-	-.239
10th decile	-	-	-.757***
Assets under mgmt quintiles (vs 1st quintile)			
2nd AUM quintile	-.073	-.064	-.056
3rd AUM quintile	-.097	-.102	-.072
4th AUM quintile	-.126	-.144	-.063
5th AUM quintile	-.607***	-.639***	-.332*
# of employees	-.137***	-.131**	-.148***
Constant	-1.326***	-1.226***	-.932***

Note: *= $p < .05$; **= $p < .01$; ***= $p < .001$

Tables 7-9 all produce similar findings and demonstrate that potential conflicts of interest like dual registration and having previous ethical violations are negatively associated with having a greater proportion of high net worth clients and positively associated with having a higher proportion of low net worth clients.

Table 7. Binary logistic regression results for Ethical Violations.

ETHICAL VIOLATIONS	β	β	β
Proportion of low net worth clients (vs < 10%)			
11-50% low net worth clients	.024	-	-
50%+ low net worth clients	.271*	-	-
Proportion of high net worth clients (vs < 10%)			
11-50% high net worth clients	-	-.279**	-
50%+ high net worth clients	-	-.373***	-
Account size deciles (vs 1st decile)			
2nd decile	-	-	-.018
3rd decile	-	-	-.336*
4th decile	-	-	-.376*
5th decile	-	-	-.620***
6th decile	-	-	-.599***
7th decile	-	-	-.632***
8th decile	-	-	-.530**
9th decile	-	-	-.643***
10th decile	-	-	-.635**
Assets under mgmt quintiles (vs 1st quintile)			
2nd AUM quintile	-.311*	-.303*	-.279*
3rd AUM quintile	-.392**	-.391**	-.290*
4th AUM quintile	-.765***	-.768***	-.576***
5th AUM quintile	-1.179***	-1.229***	-.885***
# of clients	.127***	.137***	.070
# of employees	.969***	.960***	..961***
Constant	-3.095***	-2.750***	-2.461***

Note: *= $p < .05$, **= $p < .01$, ***= $p < .001$

Table 8. Binary logistic regression results for Dual Registered as Broker.

DUAL REGISTRATION as Broker/Dealer	β	β	β
Proportion of low net worth clients (vs < 10%)			
11-50% low net worth clients	.228*	-	-
50%+ low net worth clients	.295**	-	-
Proportion of high net worth clients (vs < 10%)			
11-50% high net worth clients	-	.009	-
50%+ high net worth clients	-	-.260**	-
Account size deciles (vs 1st decile)			
2nd decile	-	-	-.160
3rd decile	-	-	-.002
4th decile	-	-	-.193
5th decile	-	-	-.349*
6th decile	-	-	-.450**
7th decile	-	-	-.511***
8th decile	-	-	-.874***
9th decile	-	-	-1.015***
10th decile	-	-	-1.400***
Assets under mgmt quintiles (vs 1st quintile)			
2nd AUM quintile	-.238*	-.234*	-.162
3rd AUM quintile	-.388***	-.393***	-.207
4th AUM quintile	-1.211***	-1.216***	-.861***
5th AUM quintile	-2.412***	-2.456***	-1.710***
# of clients	.353***	.362***	.196***
# of employees	.657***	.651**	.656***
Constant	-2.968***	-2.700***	-1.971***

Note: *= $p < .05$, **= $p < .01$, ***= $p < .001$

Table 9. Binary logistic regression results for Employees that are Registered Reps of a Broker-dealer.

Employees that are Registered Reps of a Broker/Dealer	β	β	β
Proportion of low net worth clients (vs < 10%)			
11-50% low net worth clients	.151*	-	-
50%+ low net worth clients	.368***	-	-
Proportion of high net worth clients (vs < 10%)			
11-50% high net worth clients	-	-.262***	-
50%+ high net worth clients	-	-.595***	-
Account size deciles (vs 1st decile)			
2nd decile	-	-	-.262*
3rd decile	-	-	-.232*
4th decile	-	-	-.283*
5th decile	-	-	-.605***
6th decile	-	-	-.672***
7th decile	-	-	-.849***
8th decile	-	-	-.933***
9th decile	-	-	-.844***
10th decile	-	-	-.509**
Assets under mgmt quintiles (vs 1st quintile)			
2nd AUM quintile	-.106	-.084	-.065
3rd AUM quintile	-.325***	-.301***	-.212*
4th AUM quintile	-.942***	-.902***	-.729***
5th AUM quintile	-1.640***	-1.657***	-1.368***
# of clients	.301***	.302***	.249***
# of employees	.830***	.811**	.809***
Constant	-1.975***	-1.448***	-1.187***

Note: *= $p < .05$, **= $p < .01$, ***= $p < .001$

Conclusions

Consumers find it difficult to discern the differences between a number of professionals holding themselves out to the public as an 'investment adviser' or 'financial adviser' in terms of compensation structure[5] and quality of service. Professionals find it difficult to balance the interests of the consumer, the firm employing them, and their own self interests.

These data seem to help illustrate why previous research done in the wake of the FPA v SEC lawsuit, suggest that consumers know very little about what might be important factors to consider when selecting one investment adviser from another (Hung, et al., 2008; TD Ameritrade, 2009). Recent research from the Survey of Consumer Finances, indicates that approximately one-fourth of consumers spend almost no time searching out the differences between different financial products and financial services (Bucks, Kennickell, Mach, & Moore, 2009).

In general, the results of this study support the hypotheses that lower net worth clients are more likely to hire RIA firms with greater potential conflicts of interest. Specifically, lower net worth consumers are more likely to hire an investment adviser who has committed previous ethical violations, dual registration as a broker-dealer, and charges commissions. Higher net worth clients are less likely to hire RIA firms with greater conflicts of interest, further suggesting there is a difference in competence and financial sophistication between higher net worth clients

[5] Although RIA firms report receiving a compensation type, the present dataset does not indicate the frequency or magnitude with which that compensation type is utilized. Despite a large number of RIA firms reporting that they do receive fixed fees or hourly charges, it is quite rare for firms to actually charge these forms of compensation in practice. Commissions on the other hand, are only represented amongst a minority of RIA firms, but are used so often and by so many employees at each firm that they represent an enormous (but undeterminable with the present dataset) portion of total client-advisor transactions in the U.S. with a significant economic impact.

and their lower net worth counterparts. While asset fees offer operational advantages to RIA firms and provides the benefit of increasing economies of scale, eliminating commissions from the financial services profession entirely may further exacerbate the perception that professional financial advice is only available to a small percentage of high net worth Americans.

Commissions.

Commissions are associated with lower net worth clients and smaller account sizes. They are also associated with firms with a larger number of employees. When England and Australia recently banned commissions on financial products, opponents argued that doing so will negatively impact lower net worth clients and will eliminate a number of jobs in the industry. The results from this study appear to lend some empirical support to those arguments. Eliminating commissions would have a disproportionate impact on RIA firms with a greater proportion of lower net worth clients. Table 9 also supports the second argument that eradicating commissions will reduce the amount of professionals providing financial advice. Firms with more employees are more likely to charge commissions.

Robinson (2007) argues that while there are obvious conflicts of interest associated with commissions, perhaps the differences in regulation between RIA's with a fiduciary standard and broker-dealers with a "suitability" standard accounts for a majority of the negative sentiment towards commissions. If that was the case, getting rid of commissions (which will affect low net worth clients, and a large number of professionals) might not be as fruitful for regulators and policy makers attempting to protect and aid consumers as getting rid of the "suitability" standard of care and increasing the competency requirements for investment advisers.

Implications.

Low net worth consumers need professional advice, but tend to hire professionals that have greater potential conflicts of interest and therefore would require more monitoring costs and oversight from a competent client who could properly evaluate the actions of the agent to ensure they are in the clients' best interest. Because information asymmetries exist, and low net worth clients are unlikely to have sufficient levels of human capital or financial sophistication to do so, policy makers, need to engage in paternalistic efforts to protect consumers from self-interested agents and from their own ignorance (Ciccotello, Grant, & Dickie, 2003).

Financial advisers are put in a difficult position when they must simultaneously consider the interests of the principals, the firms that hired them, external product providers, and their own self-interest (Jackson, 2008). Because all parties in the transaction are believed to be utility maximizers, it is to be expected that agents will not always act in the best interests of the principal (Jensen & Meckling, 1976). If policy makers created a strong fiduciary standard for all financial advisers, then the adviser would face fewer dilemmas between working for the firm and the client and would have a very clear objective – to put the interests of the consumer first and foremost. It is possible that more consumers would be willing to seek out professional advice if such a fiduciary standard were in place.

Eliminating commissions entirely as done in England and Australia *would* appear to have a disproportionate negative impact on lower net worth consumers and would appear to reduce the amount of professionals in the financial services industry. While it would eradicate one potential conflict of interest, it would do nothing to impact other potential conflicts of interest like dual registration as a broker-dealer. An alternative solution—one which would require a fiduciary status for *all* investment advisers and broker-dealers—would offer protections to low net worth consumers who are unequipped to distinguish between various professionals in the buyer beware

marketplace. While at the same time still allowing firms and agents to hire a large number of professionals and pay them relative to their production via commissions. Future research is necessary to determine if more American consumers would be willing to seek out professional financial advice if the costs are more salient and the conflicts of interest between principal and agent were reduced.

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