

FIDUCIARY STANDARD:

FINDINGS FROM ACADEMIC LITERATURE

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This report provides an overview of theory and empirical evidence related to the benefits and costs resulting from the application of a fiduciary standard of care to the conduct of brokers, dealers and investment advisers. An in-depth review of the extant literature related to the regulation, incentives, and outcomes of the existing advice marketplace is provided.

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EXECUTIVE SUMMARY

Assessing the possible benefits and costs from changes in the regulation of financial advisors requires consideration of how existing differences between standards of care affect advisor incentives.

The accompanying literature review provides analysis and information informing the following SEC “Request for Data and Other Information Relating to the Current Market for Personalized Investment Advice”: (from SEC Release No. 34-69013; IA-3558; File No. 4-606; Part II, Duties of Brokers, Dealers, and Investment Advisers)

1. *Data and other information, including surveys of retail customers, describing the characteristics of retail customers who invest through a broker-dealer as compared to those who invest on the basis of advice from an investment adviser as well as retail customer perceptions of the cost/benefit tradeoffs of each regulatory regime.*
2. *Data and other information describing the types and availability of services (including advice) broker-dealers or investment advisers offer to retail customers.*
3. *Data and other information describing the extent to which different rules apply to similar activities of broker-dealers and investment advisers, and whether this difference is beneficial, harmful or neutral from the perspectives of retail customers and firms.*
6. *Data and other information describing and comparing the security selections of retail customers who are served by financial professionals subject to the two existing regulatory regimes.*
9. *Data and other information related to the ability of retail customers to bring claims against their financial professional under each regulatory regime, with a particular focus on dollar costs to both firms and retail customers and the results when claims are brought.*
10. *Data and other information describing the nature and magnitude of broker-dealer or investment adviser conflicts of interest and the benefits and costs of these conflicts to retail customers. Describe the nature and magnitude of broker-dealer or investment adviser conflicts of interest with the type and frequency of activities where conflicts are present, and describe the effect actions to mitigate conflicts of interest have on firm business and on the provision of personalized investment advice to retail customers.*
12. *Data and other information describing the effectiveness of disclosure to inform and protect retail customers from broker-dealer or investment adviser conflicts of interest.*
13. *Identification of differences in state law contributing to differences in the provision of personalized investment advice to retail customers.*
14. *Data and other information describing the extent to which retail customers are confused about the regulatory status of the person from whom they receive financial services. Provide data and other information describing whether retail customers are confused about the standard of conduct the person providing them those services owes to them. Describe the types of services and/or situations that increase or decrease retail customers’ confusion and provide information describing why. Describe the types of obligations about which retail customers are confused and provide information describing why.*

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This study attempts to aggregate information and analysis related to these questions using three sources: academic theory, legal literature review, and an independent review of published research and studies related to fiduciary. Expert advice theory helps us understand the relationship between an advisor and investor as a transaction between an agent and a principal. Literature on principal/agent relationships also provides insight into how the costs of self-serving behavior can be reduced in order to predict the effectiveness of alternative approaches within the advisor marketplace. A review of legal literature related to the application of a fiduciary standard within the medical profession is also examined to illustrate how a fiduciary standard of care could operate within the advice profession. Empirical evidence illustrates differences in client characteristics by form of advisor compensation.

Summary of findings

- Commission compensation and hourly charges are most common among investment advisers that cater to moderate wealth clients.
- Financial planning services are more frequently provided among dually registered investment advisers/brokers who are compensated through commissions, hourly charges and fixed project or retainer fees, and are less common among investment advisers who receive compensation only from assets under management.
- A suitability standard gives broker-dealers greater latitude when making product recommendations to retail investors. This latitude also creates wide-ranging incentives particularly if consumers are unable to recognize self-serving recommendations.
- Mutual fund performance comparisons show that broker-recommended funds significantly underperform direct-channel funds more commonly recommended by investment advisers.
- Simplified price disclosure can substantially improve the efficiency of the financial advice marketplace given the multidimensionality of costs to investors.
- Conflict of interest disclosure appears to be ineffective and possibly counterproductive.
- A stricter fiduciary standard of care within some states does not limit the supply of broker-dealer agents within those states, and does not affect their ability to recommend products or cater to lower-wealth clients.
- There is no evidence that retail investors recognize differences in standards of care. This lack of recognition contributes to vulnerability involving self-serving recommendations.
- A fiduciary standard of care in medicine gives professionals an incentive to invest in knowledge and to recommend products that meet a minimum standard.

This document provides an overview of theory and empirical evidence related to the benefits and costs resulting from the application of a fiduciary standard of care to the conduct of broker, dealers (broker-dealers) and investment advisers. The purpose of this document is not to advocate a position on possible regulatory actions. It is intended to provide an in-depth review of the extant literature, primarily from economics, finance and law, related to the regulation, incentives, and outcomes of the existing advice marketplace. Opinions on the likely impact of various strategies on the marketplace are entirely those of the author and are based on the preponderance of empirical evidence and the strength of related theories.

I first provide a brief overview of economic theory related to the application of a fiduciary standard of care to professionals who provide expert advice. I then review the legal literature related to the application of a fiduciary standard of care to help predict how the application of a legal fiduciary standard of care will impact broker-dealers. I then provide responses to specific requests for data and information for which academic research exists, including a number of studies conducted by the author related to financial advice regulation.

EXPERT ADVICE THEORY

Advice and Agency Conflict

Any advice profession necessarily involves an imbalance of information between the principal (in this case the retail investor) and the agent (the investment adviser or registered representative, collectively, 'advisor'). This information imbalance is what drives demand for the service. Without it, there is no incentive for retail investors to pay for advice.

This conflict of interest between investor and advisor creates what is commonly referred to as agency costs. The difference between the ideal recommendation and the self-serving recommendation is greater when it is more difficult for the retail investors to detect lower-quality advice.

Mullainathan, Nöth, and Schoar (2012) provide perhaps the clearest evidence of agency costs that exist when a retail investor relies on the advice of a financial professional. Mock customers with one of four current portfolios (all cash, index funds, a large position in company stock, and a large position in sector funds) sought out portfolio recommendations from advisors. Since these professionals were compensated through product sales, they favored recommendations that provided greater remuneration to recommendations that were objectively optimal. However, for clients with highly inefficient current portfolios (cash, company stock), the advisors gave recommendations that were clearly welfare enhancing. The difference between the inefficient portfolio and the improved portfolio represents the benefit from using an agent. The difference between the ideal and the recommended portfolio represents the agency cost.

This cost may still make the investor better off than they would have been without an advisor. A rational investor aware of the cost of advice may anticipate and tolerate suboptimal recommendations if the outcome is better than it would have been without an advisor. Any delegation of decision making will likely involve some agency costs - even with an advisor held to a strict fiduciary standard of care. An efficient equilibrium will exist when each party is aware of these costs and chooses to participate in an agency contract. If third parties (like government) step in to significantly reduce these agency costs, it is possible that an agent may no longer choose to participate.

Added compensation in the form of agency conflicts does increase the supply of financial advice. This increases the number of advisors within the industry and possibly increases the percentage of consumers who

receive some advice. Gennaioli, Shleifer and Vishny (2012) propose that retail investors may be unlikely to participate in capital markets that provide a valuable risk premium without the help of an advisor. If the benefits to the retail investor exceed the costs of advice, the market improves social welfare despite agency costs. A study of the decline in whole life insurance over the past 20 years (Mulholland, 2013) shows clearly how market forces, primarily internet sales of term insurance, led to a large increase in welfare among sophisticated consumers (direct channel) while also sharply reducing insurance protection among less sophisticated consumers (broker channel) who were more likely to be sold commission insurance products. The loss of product sales through commission-compensated brokers in the insurance industry that occurred as a result of direct channel competition did not have unambiguous welfare improvements among clients who were previously sold products by advisors motivated by compensation tied to financial products.

The conclusions of Gennaoli et al. (2012) rest on the improved welfare from equity market participation. Fama and French (2002) provide evidence that the equity premium has declined in the United States, and Asness (2012) suggests that current equity valuations imply a risk premium only about 50 basis points higher than the average mutual fund expense ratio. If the spread between unadvised and advised outcomes is not that great, then the net welfare impact of using an advisor will be modest or even negative. Comparison of advised and unadvised client accounts in Germany show few welfare benefits (Hackethal and Inderst, 2013), although the authors are unable to compare the possible benefits of equity market participation among individuals who may never have opened an investment account. Blanchett and Kaplan (2012) find that an advisor well-versed in tax and portfolio strategies can easily provide value above the added costs of professional management. This assumes that advisors within the industry have the knowledge needed to make welfare-enhancing recommendations.

Reducing Agency Cost

Jensen and Meckling (1976) describe three methods a principal (retail investor) can use to reduce the likelihood of self-serving advice - monitoring, contracting and bonding. Monitoring can include the use of disclosure to allow an investor to more easily recognize the costs of advice, or using some other method of oversight to ensure that recommendations are not excessively self-serving.

Retail investors are often ill-equipped to judge the quality of advice. Even with disclosure, many investors do not have the knowledge of financial theory or product characteristics to estimate quality. An alternative is to hire another agent, for example a government regulator, to monitor the activities of agents to limit self-serving behavior. At equilibrium, an investor will expend resources (including time and taxes spent on regulation) up to the point at which the expected gains from reduced agency costs equal the cost of monitoring. Policies that emphasize greater disclosure are intended to reduce monitoring costs for individuals. It is again worth noting that it is inefficient for the individual or a government entity to spend more on monitoring than is expected to be gained by retail investors.

Contracting to reduce agency costs relates to the various methods through which financial advisors are compensated. The ideal contract is one which provides enough of an incentive to convince an advisor to provide advice without creating excessive agency costs for the investor. Different methods of compensation involve different potential incentives and agency costs. These will be discussed later in greater detail, but it is important to note that, in advisor contracting, the balance that exists between maintaining the availability of advice and ensuring that the advice given makes retail investors better off.

Bonding refers to actions voluntarily undertaken by an advisor to reduce the perception of agency costs by an investor. Membership in an organization that requires a more benevolent standard of care between an

advisor and a client provides a signal of reduced agency costs to a retail investor. Professional certifications can provide both a signal of advisor capability and of reduced agency costs. Advisors holding the Certified Investment Management Analyst® or Certified Private Wealth Advisor® certifications, for example, agree to "always place the financial interests of the client first" to ensure that "recommendations to clients and decisions on behalf of clients shall be solely in the best interest of the client."¹ This may expose advisors to public censure or possibly to litigation risk - a cost borne in order to increase investor trust and demand for advising services.

Agency conflicts also put less high-quality advice in question if a consumer is unable to differentiate between high-quality and low-quality advice. Akerlof (1970) provides a well-known model explaining inefficiencies created within markets where sellers know more than buyers about product quality. Those offering higher quality products, for example more efficient investment instruments, cannot compete effectively against advisors recommending less efficient funds if retail investors aren't able to tell the difference. With higher margins, the advisor selling less efficient instruments will have greater resources available for marketing, will be able to pay higher salaries to attract more productive advisors, and will open more (and more attractive) offices. Ultimately, however, excessive agency costs can cause investors to abandon a market - reducing welfare for both buyers and sellers. The industry may decide to limit abusive behavior by self-policing in order to prevent low-quality advice, for example through a self-regulatory organization.

Economics of Suitability

Suitability standards place explicit restrictions on self-serving behavior. They are typically characterized as rules-based because compliance often involves following a set of procedures and avoiding restricted practices. Both suitability and fiduciary standards limit self-serving behavior, but there are differences in the incentives within each model. If we assume that, consistent with agency theory, the objective of an advisor is to maximize their expected revenue per unit of advising effort, then both suitability and fiduciary models predict some self-serving behavior by advisors. In a suitability model, the incentive is to make recommendations that provide the highest present value of income within the existing constraints provided by the regulator.

A simple sports analogy is that a pitcher will tend to hit the corners of a strike zone designated by the umpire in order to gain an advantage over the batter. For example, breakpoints in mutual fund compensation allowed advisors to receive greater compensation by recommending that clients invest at, or just below, the breakpoint threshold in each fund (Federal Register, 2004). This allowed registered representatives to split a portfolio among a number of funds in order to maximize revenue (per unit of effort) rather than taking advantage of opportunities to enhance client welfare by obtaining breakpoint discounts. Exposure of this practice led to additional rules increasing disclosure and limiting self-serving behavior. A rules-based standard often evolves as regulators respond to evidence of abusive advisor behavior.

The lack of a fiduciary standard of care coupled with contracting incentives can also encourage advisors to cater to, and perhaps amplify, welfare-reducing investor biases. Investors' tendency to chase returns in mutual funds leads them to underperform average market returns by 1.56% per year since they tend to buy overvalued sectors after prices have risen and to sell following a market decline (Friesen and Sapp, 2007). This underperformance was significantly greater in commission funds, perhaps because advisors benefitted from acceding to investor demands to buy and sell funds at a greater frequency. Anagol, Cole and Sarkar (2012) find that commission-compensated insurance agents will play into a client's biases if these biases help

¹ IMCA Code of Professional Responsibility. Available at <http://www.imca.org/sites/default/files/Code.pdf>

them sell a higher commission product. They also find that agents will consistently recommend higher commission products to less sophisticated consumers, leading to welfare losses that are greatest among those who can least afford to sustain them. The latitude of recommendation quality allowed in a suitability model is particularly troubling when clients are older and have experienced cognitive decline that may reduce their ability to perceive self-serving recommendations (Finke, Howe and Huston, 2011). In the absence of a fiduciary standard, Anagol et al. find that there appears to be no market mechanism that can overcome self-serving recommendations if the buyer does not realize the recommendation was suboptimal.

While many registered representatives do not take advantage of opportunities to maximize revenue within a suitability regime, incentives exist that reward advisors who are aware of opportunities to make self-serving recommendations. It is up to the regulator to define the limits of agency costs, and maintaining these limits requires constant monitoring of possible self-serving behavior as product innovation creates potential conflicts of interest. It can be argued that a significant amount of development resources within the financial services industry will inevitably be directed toward the creation of products that allow representatives to extract more resources from individuals within the boundaries of suitability. Thus, a significant source of inefficiency within a suitability regime is related to advisor and product innovation incentives.

Economics of a Fiduciary Standard of Care

Fiduciary laws limit abusive practices by exposing advisors to the threat of litigation or penalties by a regulatory agency. This serves as an institutional bonding mechanism intended to increase quality of advice by forcing an advisor to weigh the cost of liability against the potential benefits of self-serving advice. The advisor then must weigh the likelihood and magnitude of possible penalties or litigation against the potential benefit of self-serving behavior.

Laby (2010) notes that there is a general lack of legal precedent about what constitutes a breach of fiduciary duty under the 1940 Investment Advisers Act. According to Section 206 of the Advisers Act, it is unlawful to "engage in any act... which is fraudulent, deceptive, or manipulative." While fraudulent or deceptive advice is more unambiguous, it is likely that far more investor welfare is lost from the more seemingly benign agency costs associated with mildly self-serving recommendations². The primary distinguishing feature between fiduciary and suitability standards in the United States is the method of compensation (fees versus commission) and the potential punishment for exceedingly self-serving recommendations (FINRA penalties and arbitration losses versus civil judgments and federal penalties).

While incentives to provide self-serving advice are similar within both fiduciary and suitability regimes, other incentives of a fiduciary standard of care may lead to better market outcomes. Prudent investor standards (formerly known as prudent man) impose a duty of care on the advisor to know what recommendations are most appropriate. This requires a certain degree of competence, which gives advisors a reason to invest in the knowledge needed to make an appropriate, defensible recommendation. To the extent that FINRA rule 2111 requires "reasonable diligence" by an advisor when recommending a specific strategy, it can be

² Both FINRA and SEC general suitability standards are increasingly similar. Rule 2111 of the FINRA manual, recently updated to include new bases for making investment recommendations, states that an advisor must consider "the customer's investment profile" which includes "the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose..." Under SEC Release No. IA-1406, which was never adopted but nonetheless considered by SEC staff to be an operative requirement for investment advisers, the proposed suitability standard implies that suitable recommendations include making "a reasonable inquiry into the client's financial situation, investment experience, and investment objectives."

argued that this incentive also exists among broker-dealers. Compensation that is decoupled from product recommendations creates an environment in which advisors may be more likely to recommend efficient financial instruments. This gives financial services firms a motivation to create low-cost, innovative products as they cater to demands of advisors who benefit from providing greater value to clients. The welfare cost to retail investors of differences in contracting is easier to quantify than differences in service quality.

Fee Disclosure

Both investment advisers and broker-dealers are subject to disclosure requirements. Evidence of the effectiveness of fee and conflict of interest disclosure at reducing agency costs is mixed. Improved pricing information has transformed the efficiency of some financial markets. For example, Bar-Gill (2012) provides insight into how APR disclosure through the Truth in Lending Act allowed consumers to easily compare fees and interest rates in the mortgage market. The purpose of disclosure is to provide important information that helps consumers make better decisions. In the market for investment advice, disclosure should give consumers full information that distills the myriad costs of receiving advice in a simple format that improves choice outcomes. This is particularly true for opaque costs that are common within the industry. Bar-Gill notes "multidimensionality" (page 125) such as the deferral of some costs and the combination of fees and expenses that characterize highly complex financial products as a significant barrier to consumer choice. The APR created an easy-to-compare metric that combined these costs into a single present value number that appears to improve consumer outcomes successfully and to increase product quality within the mortgage market.

The most important economic benefit of fee simplification in cost disclosure is that, by monetizing all costs, producers no longer have an incentive to increase product complexity. This incentive to shroud attributes is examined in a model by Gabaix and Laibson (2006). Producers will rationally segment the market by level of investor sophistication. Less efficient, more opaque products will be created to maximize economic rents from less sophisticated consumers while more competitive products will be simultaneously offered to sophisticated consumers. In the absence of an easy-to-compare metric, producers will emphasize non-salient characteristics to the less sophisticated. Examples of product differentiation through opaque characteristics are evident in the mutual fund market.

Current fund disclosure actually appears to encourage inefficient fund choice by prominently displaying recent returns³. Beshears, Choi, Laibson and Madrian (2010) find that consumers consistently choose more expensive S&P 500 funds (which have no quality differences) using simplified fund disclosures that feature past returns if the period of prior returns is more favorable. Stoughton, Wu and Zechner (2011) show evidence that the market for active funds is differentiated between less sophisticated investors, who fund families attract through marketing, and more sophisticated, direct-channel investors who are targeted through higher performance. This is consistent with evidence that successful mutual funds appear either to gain market share through lower expenses or by increasing opaque fees which are then used to incent advisor recommendations (Khorana and Servaes, 2012). During a brief period in India when closed-end fund were allowed to shroud expenses in a manner similar to 12b-1 fees, there was a spike in the initiation of closed-end funds (Anagol and Kim, 2012). And when opaque fund characteristics were made more transparent, their quality (measured through net performance) appears to increase (Edelen, Evans and Kadlec, 2012).

³ If disclosure does not improve the ability of a consumer to reduce agency costs, it will likely receive significant support as a policy solution from firms who benefit from opaque markets. In fact, complex disclosure may further reduce a consumer's ability to compare and force them to rely more on the expert advisor to recommend appropriate financial products. Mulholland, Finke and Gilliam (2013) find evidence that life insurance disclosures which provide optimistic forecasts of product quality are favored by agents who benefit the most from their use as a marketing tool.

Edelin et al. also find that more opaque bundled expenses increase consumer flows to these funds - evidence that, in the absence of effective disclosure, producers will increase product complexity and reduce product quality. Perhaps the greatest potential increase in retail investor welfare from disclosure is the improvement in investment product quality.

It is important that disclosure be consistent among competing financial products across the financial services industry. Anagol, Cole and Sarkar (2012) show experimental evidence that increasing cost disclosure for one category of financial products does improve the quality of products recommended by the agent. It also has the perverse effect of causing many agents to no longer recommend that category of products and to instead recommend products with more opaque expenses. If cost disclosure requirements among broker-dealers are improved, it is possible that agents will engage in regulatory arbitrage by preferring to recommend products, for example insurance products that may be subject to different disclosure standards, that allow them to take advantage of more opaque price information.

Conflict of Interest Disclosure

Conflict of interest disclosure appears to be far less effective than simplified cost disclosure, and may even be counterproductive. This is particularly true in the financial advice market where the relationship between client and advisor is based on trust, and there are often social ties between advisor and client (such as referrals or the common practice of soliciting clients among acquaintances). These social ties create what Sah, Loewenstein and Cain (2013) term "insinuation anxiety," where the disclosure of a conflict of interest by an advisor pressures an investor into either accepting the advice or admitting that they do not trust the advisor to overcome their conflict of interest. There is evidence that the client may be even more likely to accept self-interested advice following conflict of interest disclosure because of this effect - particularly if the disclosure is made in person. Distancing the conflict of interest disclosure from acceptance of advice, for example by requiring that a client accept recommendations while not in the presence of the advisor, may be impractical. Disclosure may also reduce the disutility an advisor experiences from making a self-serving recommendation. Cain, Loewenstein and Moore (2005) show that advisors are more inclined to give self-serving recommendations after they have disclosed a conflict of interest. Since the client now knows that the advice may favor the advisor, the advisor feels less moral compulsion to make a recommendation in the client's best interest. Conflict of interest disclosure is a tempting policy solution because it absolves advisors from responsibility, reduces sympathy for retail investors who have been given self-serving advice, and allows regulators to feel as if they have created a policy solution without the fear of antagonizing those in the industry who benefit from self-interested advice.

Among the most important possible determinants of high-quality advice is advisor competence. Unfortunately, there appears to be far more variation in advisor knowledge than exists in professions with more established mechanisms for ensuring minimum quality standards. Quality standards vary significantly among registered representatives and investment adviser representatives. However, none of the exams necessarily give an advisor the information they need to provide high-quality advice to individuals for all of the services advertised. A fiduciary standard may motivate advisors to invest in knowledge in order to reduce the risk of providing bad advice. Relying on advisors to decide how much knowledge to obtain, however, may be an inefficient way to ensure minimum capability within the advising industry and may also lead to poor outcomes for retail investors who are often unable to discern an advisor's capability, even after receiving a recommendation. Advisors may also be motivated to obtain a voluntary certification mark as a signaling mechanism to increase demand for their services. Increasing the incentive to invest in knowledge and ensuring that certifications provide useful information about an advisor's capability should be a policy objective.

The number of credentialing programs in financial services is overwhelming, but third-party accreditors that assess the quality, objectivity and credibility of personnel certifications exist for this reason. There are two predominant bodies that accredit certification programs in the U.S.: the National Commission of Certifying Agencies and the American National Standards Institute.

LEGAL ASPECTS OF APPLYING A FIDUCIARY STANDARD OF CARE

Fiduciary responsibilities continue to expand across a variety of agency relationships (Frankel, 1983; Easterbrook & Fischel, 1993). This section provides an overview of how standards of care are viewed in other professions, namely medicine and law. This section does not provide a treatise on the particular aspects of a fiduciary standard of care regarding what duties may or ought to be included in such a standard of care. We seek to provide insight from other professions as it relates to the application of a fiduciary standard of care to broker-dealers.

Impact of Tort Law on Practice Standards in Medicine

Like the financial advice profession, patients place considerable trust in their medical professionals and the advice they receive. Regarding one particular aspect of this physician-patient relationship, *Hammonds v. Aetna Casualty & Surety Company* (1965) described the fiduciary responsibility that physicians have regarding their patients' information. Physicians, like financial professionals, owe a standard of care to their patients.

The definition of the standard of care required of medical professionals has changed over time as a result of court rulings in malpractice cases (Moffett & Moore, 2009). Originally, the standard of care was judged against customary practices employed in a particular field (Moffett & Moore, 2009). An example of this standard of care is articulated in *Garthe v. Ruppert* (1934). Although outside the realm of medicine – *Garthe v. Ruppert* (1934) dealt with the safety practices employed at a brewery – the required standard of care is described as the “customary way of doing things.”⁴

Around the same time as *Garthe v. Ruppert* (1934), another court case expanded the definition of the standard of care. *The TJ Hooper* (1932) dealt with a tug boat that lost two barges during a storm. The court argued that, even though it was not customary at the time for tug boats to use radios to receive storm warnings, the practice was reasonable and ought to be employed. The case extended the standard of care beyond requiring what is customarily practiced by recognizing that “a whole calling may have unduly lagged in the adoption of new and available devices.” (*The TJ Hooper*, 1932).⁵ As stated in Moffett and Moore (2009), “... if there is a practice that is reasonable but not universally ‘customary’ it may still be used as a measure of the standard of care.” (p.110).

The “standard of reasonable prudence” was referenced as early as 1903 (*Texas & Pacific R. Co. v. Behymer*, 1903)⁶ and was quoted in a later case regarding medical malpractice (*Helling v. Carey*, 1974). In *Helling v.*

⁴ Full quote from *Garthe v. Ruppert* (1934): “One man is not obliged to run his business the same as some other man, nor can he be judged before the law according to the methods employed by others. When, however, a custom has prevailed in the trade or in the calling, or certain dangers have been removed by a customary way of doing things safely, this custom may be proved to show that a manufacturer or any one else employing men has fallen below the required standard.”

⁵ Full quote from *The TJ Hooper* (1932): “Although the general practice of the calling is sometimes determined to be the standard of proper diligence, since in most cases reasonable prudence is in fact common prudence, but strictly it is never its measure, because a whole calling may have unduly lagged in the adoption of new and available devices.”

⁶ Full quote: “What usually is done may be evidence of what ought to be done, but what ought to be done is fixed by a standard of reasonable prudence, whether it usually is complied with or not.”

Carey (1974), the Supreme Court decided that, although it was not customary for ophthalmologists at the time to test patients younger than 40 for glaucoma (because occurrences of the disease were so rare at younger ages), the ophthalmologists ought to have administered the relatively inexpensive test for glaucoma because earlier detection could have prevented blindness in the plaintiff. In other words, “reasonable prudence” required the administration of the test, even though the test was not customarily performed at younger ages.

Although some argue that *Helling v. Carey* (1974) was an exceptional case that did not establish precedence for other states (Kelly & Manguno-Mire, 2008), the case appears to have influenced the future standard of care of the ophthalmology profession. After *Helling v. Carey* (1974), testing for glaucoma increased for patients under 40, which Ruskiewicz, Godio, Myrowitz, & France (1983) argue brought additional costs without observable changes in quality of care.

Quite opposite to *Helling v. Carey* (1974), *Hall v. Hilbun* (1985) suggests that a minimum standard of care is all that is necessary by stating:

When a physician undertakes to treat a patient, he takes on an obligation enforceable at law to use minimally sound medical judgment and render minimally competent care in the course of the services he provides.

The comparison for the standard of care at this point is “minimally sound medical judgment” and “minimally competent care.” Further, *Hall v. Hilbun* (1985) shifts emphasis away from determining whether a particular practice is customarily done, or whether a favorable practice is reasonable. Instead, the case emphasizes the judgment and competency of the professional and whether those characteristics meet a minimum standard. In other words, rather than emphasizing the act or practice performed (i.e., the behavior of the medical professional), this case suggests that the standard of care ought to assess the cognitive efforts of the medical professional (i.e., the thoughts and judgment employed to guide the behavior of the medical professional).

More recently, *McCourt v. Abernathy* (1995) provides important insight about the standard of care as it stands today. The judge in *McCourt v. Abernathy* (1995) gave instructions to the jury that clarify that a “mere mistake of judgment” alone does not mean that the physician was negligent.⁷ In other words, the court allows for professionals to make honest mistakes as long as they meet the standard of care. Further, the judge specifies that medical professionals do not all practice in the same manner and that differences in practices do not suggest negligence:

The mere fact that the plaintiff's expert may use a different approach is not considered a deviation from the recognized standard of medical care. Nor is the standard violated because the expert [witness] disagrees with a defendant as to what is the best or better approach in treating a patient. Medicine is an inexact science, and generally qualified physicians may differ as to what constitutes a preferable course of treatment. Such differences to preference under our law do not amount to malpractice.

Instead, the judge suggests that the standard of care must be consistent with the “degree of skill which it is the duty of every practitioner practicing in his specialty to possess.” Further, the judge stated:

⁷ Full quote: Ladies and Gentlemen, when a physician exercises ordinary care and skill in keeping within recognized and proven methods, he is not liable for the result of a mere mistake of judgment or for a bad result which does not occur because of any negligence on his part. There is no responsibility for error of judgment or for a bad result unless it is so negligent as to be inconsistent with that degree of skill which it is the duty of every practitioner practicing in his specialty to possess.

I further charge you that the degree of skill and care that a physician must use in diagnosing a condition is that which would be exercised by competent practitioners in the defendant doctor's field of medicine. In South Carolina the question of whether a physician, in making a diagnosis deviated from the applicable standard of care either by not employing a particular procedure or by not ordering a particular test is to be determined by what an ordinary careful and prudent physician would have done under the same or similar circumstances.

The standard of care, then, must be consistent with what a “prudent physician” would do. The judge also makes it clear that this duty of a “prudent physician” rests on “every practitioner practicing in his specialty.” In other words, the standard of duty is consistent across professionals, based on the fact that they practice in a particular specialty and is not determined by regulatory regime.

Although the standard of care in the medical profession appears to have adapted to changes in the profession over time, case law does not seem to suggest that multiple standards of care existed at the same time. In other words, physicians performing similar procedures appear to be held to the same standard of care, regardless of any regulatory oversight. The same approach seems appropriate for financial professionals.

The Best Interest of the Customer

The current prevailing measuring stick for the standard of care in the medical profession is whether a particular professional acted as a prudent physician would have acted. In contrast, Section 913 of the Dodd-Frank Act (2010) proposes that the standard of conduct for financial professionals who provide individual investment advice “be to act in *the best interest of the customer* without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.” (Emphasis added) Common law in other industries also provides insight about a standard of care involving the “best interest” of a customer or client. For example, *Garthe v. Ruppert* (1934), mentioned previously, states: “One is not obliged, however, to use the best methods or to have the best equipment or the safest place, but only such as are reasonably safe and appropriate for the business.” In other words, the standard of care was not necessarily that they provide the best care; rather, the standard was that they provide reasonable care. As mentioned previously, more recent cases may suggest the need of meeting only minimal standards of competency and judgment (*Hall v. Hilbun*, 1985). *Hall v. Hilbun* (1985) provides important insight about why using the average care – or even the best care – as a standard may be inappropriate:

Physicians incur civil liability only when the quality of care they render falls below objectively ascertained minimally acceptable levels. Use of such concepts as "average" are misleading and should be avoided, particularly in jury instructions, for such notions understood arithmetically suggest that the lower 50 percent of physicians regularly engage in medical malpractice. The percentage of physicians who daily deliver to their patients a legally acceptable quality of care is quite high. The terminology used, particularly in jury instructions, should reflect this reality.

If a standard requires a professional to act in the best interest of the client, rather than to demonstrate minimal competency, guidance may also be needed to explain how a professional can meet such a standard on a consistent basis. *Belmont v. MB Investment Partners, Inc.* (2013) provides recent guidance on how such a standard ought to be viewed:

The federal fiduciary standard requires that an investment adviser act in the "best interest" of its advisory client. Under the "best interest" test, an adviser may benefit from a transaction

recommended to a client if, and only if, that benefit and all related details of the transaction are fully disclosed. In addition to the clear statutory prohibition on fraud, the federal fiduciary standard thus focuses on the avoidance or disclosure of conflicts of interest between the investment adviser and the advisory client.

Fiduciaries' Responsibilities Can Be Limited In Scope

The idea of limiting the scope of a fiduciary responsibility is not new. *Hammonds v. Aetna Casualty & Surety Company* (1965) defined the fiduciary responsibility that physicians have for the information provided by their patients, specifically regarding the patient's medical file. Although medical professionals owe a standard of care to their patients, the fiduciary responsibility of that relationship is quite limited.

The Certified Financial Planner Board of Standards, Inc. (CFP Board) also limits the scope of the fiduciary duty it places on its certificants. In its *Rules of Conduct*, Rule 1.4 states:

A certificant shall at all times place the interest of the client ahead of his or her own. When the certificant provides financial planning or material elements of financial planning, the certificant owes to the client the duty of care of a fiduciary as defined by CFP Board.” (CFP Board, 2013)

Although a CFP® professional is always required to “place the interest of the client ahead of his or her own,” only “[w]hen the certificant provides financial planning or material elements of financial planning” is the fiduciary standard applied.

The Role of the Courts in Determining the Standard of Care

As mentioned previously, *The TJ Hooper* (1932) extended the standard of care beyond what was customarily practiced to include that which was also reasonable. The case also provides the opinion that “[c]ourts must in the end say what is required; there are precautions so imperative that even their universal disregard will not excuse their omission” (emphasis added). Although *Helling v. Carey* (1974) provides an example of when courts might overstep their bounds in determining what ought to be required (Kelly & Manguno-Mire, 2008), Laby (2010) alternatively argues that the fiduciary obligations of broker-dealers and investment advisers are not more clear because of “an underdeveloped jurisprudence” (p.710) on the matter. Additional court cases may provide valuable insight into what the standard of care ought to be for broker-dealers.

Despite the role courts play, they may not be the best player to determine what the standard of care ought to be. An alternative approach that is growing in the medical profession uses clinical practice guidelines (CPG). According to Kelly and Manguno-Mire (2008), CPGs “seek to guide medical decision-making” (p.306) and are produced by a variety of experts within the medical field. CPGs, therefore, allow medical professionals the ability to play a role in determining appropriate standards of care.

Legislators can also play a role in establishing the standard of care. After *Helling v. Carey* (1974), the Washington state legislature passed a statute to define the standard of care (Kelly & Manguno-Mire, 2008; Moffett & Moore, 2009). They define the standard of care for medical professionals as “that degree of skill, care, and learning possessed at that time by other persons in the same profession” (RCW 4.24.290).

Arbitration vs. Litigation

The lack of litigated cases involving claims of a breach of fiduciary duty is partially due to the mandatory arbitration agreements commonly found in brokerage agreements (Laby, 2010). Laby (2010) comments that, “Unlike court litigation, arbitration generally does not yield a well-reasoned written decision.” (p.706). Interestingly, Laby (2010) observes that “[i]n each of the past five years, breach of fiduciary duty was by far the predominate type of arbitration claim against brokers” (p.706), which is still the case (FINRA, 2013). Requiring arbitration of brokerage customers, therefore, limits the ability of courts to interpret the standard of care, and particularly the fiduciary duty, as it applies to broker-dealers.

Another result of mandatory arbitration for brokerage customers is that it creates two very different channels through which investors can pursue redress for allegations claimed against their broker or adviser. Brokerage customers, therefore, tend to arbitrate or mediate their complaints, whereas clients of registered investment advisors can litigate in court. This dual system of seeking redress makes it difficult for equal comparisons of the costs to investors for seeking such redress of brokers and advisers, although Gross (2010) argues that arbitration's most obvious advantages include an easier, faster dispute process and lower transaction costs. Further, it complicates the process of attempting to identify whether investors are compensated when their broker or adviser breaches their duty of care. The determination of liability (and client benefits) is further complicated by the fact that the majority of investment adviser representatives are affiliated with broker-dealers, and many of their retail services are integrated together.

Mandatory arbitration has arguably limited the ability of investors to challenge in court whether the advice they receive from a broker is “solely incidental” to their broker’s sales, as required of the broker-dealer exclusion in the Investment Advisers Act (1940). If the advice received is not “solely incidental,” then investors may have grounds for claiming that their broker does not actually meet the requirements of the exclusion and ought to be held to a fiduciary standard of care.

The Advisers Act seems quite clear that the exclusion ought to apply only when the advice is “solely incidental.” *Belmont v. MB Investment Partners, Inc.* (2013) recently stated that “[b]roker-dealers are exempted from 15 U.S.C.S. § 80b-6 of the Investment Advisers Act of 1940, provided that they are not otherwise acting as investment advisers.” (Emphasis added). Although the court did not address what is meant by “acting as investment advisers,” the language seems consistent with the original intent of the Advisers Act to exclude brokers only when the advice is “solely incidental.”

Belmont v. MB Investment Partners, Inc. (2013) also provides a concise definition of a fiduciary, as it relates to investment advice and can be applied to broker-dealers who provide personalized investment advice:

A plaintiff alleging a fiduciary breach must first demonstrate that a fiduciary or confidential relationship existed, which requires that one person has reposed a special confidence in another to the extent that the parties do not deal with each other on equal terms. Although no precise formula has been devised to ascertain the existence of a confidential relationship, it has been said that such a relationship exists whenever one occupies toward another such a position of advisor or counselor as reasonably to inspire confidence that he will act in good faith for the other’s interest.

IMPACT ON MODERATE WEALTH RETAIL INVESTORS

Registered Investment Advisers (RIAs) who are dually registered tend to have clients with lower average wealth than other RIAs according to both ADV forms and industry surveys (Cerulli Associates, 2012). Wirehouse broker/dealers, according to the same Cerulli Associates survey, appear to have higher average assets per client than RIAs and much wealthier clients than regional and independent broker-dealers.

In Dean and Finke (2012), we collect ADV data from the 7,403 registered investment advisers who had individual clients and at least \$25 million in assets under management as of July 2008. The median assets under management among these firms was \$115 million with about 231 accounts per firm. Since client data from broker-dealers are not publicly available, we investigate differences among registered investment advisers who must disclose compensation method and some client information on SEC form ADV.

Advisors may have an incentive to prefer asset-based fee compensation for larger clients and commission-based compensation for smaller clients. Many RIAs choose not to serve clients with lower investible assets since the fees generated from these assets are not sufficient to cover the cost of time spent providing ongoing asset management services. A number of investment adviser representatives (roughly 88%) are so-called dual registrants who provide fee-based asset advising services as well as commission-compensated products. By comparing client characteristics of RIAs who also receive commission compensation, we can gain some insight into the relation between compensation and client wealth.

We first sort into average account size by dividing total reported assets under management by the number of total client accounts for each advisor firm (See Table 1.). We find that firms with smaller average account sizes have far more client accounts than firms with larger average account sizes.

TABLE 1. MEDIAN NUMBER OF ACCOUNTS BY AVERAGE CLIENT SIZE (IN DECILES)

Deciles	Average Account Size	Median # of accounts
1st	< \$148,737	575.0
2nd	\$148,737 – 218,742	368.5
3rd	\$218,742 – 292,601	344.0
4th	\$292,601 – 396,425	280.0
5th	\$396,425 – 541,673	214.0
6th	\$541,673 – 779,221	185.5
7th	\$779,221 – 1,171,259	150.0
8th	\$1,171,259 – 2,083,535	116.0
9th	\$2,083,535 – 6,259,705	91.0
10th	> \$6,259,705	40.0

We next compare compensation method within each account size decile (See Table 2.). We find that the most frequent types of compensation among advisors with smaller client accounts are hourly fees, fixed fees, and commissions. Each of these compensation methods can potentially provide more compensation from a modest-wealth client than a traditional assets under management model, which typically clusters around 1 percent of investible assets. For example, a client with \$50,000 in investible assets may provide only \$500 of annual income under an AUM model, while a fixed-fee financial plan may cost \$1,500 to \$2,000, and commissions might provide even more compensation depending on breakpoints. We find that the proportion charging commission at the lowest account size decile is 7 times greater than at the highest account size decile (23.9% vs. 3.4%) and the proportion charging hourly fees is 5 times greater (68.6% versus 13.1%).

Table 2. percentage of ria firms & fee types by client size Deciles

Fee type (%)	1 st	2 nd	3 rd	4 th	5 th	6 th	7 th	8 th	9 th	10 th
AUM only (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
Hourly fee (47.9%)	68.6	70.3	64.9	60.9	53.2	49.1	42.7	33.6	23.0	13.1

Fixed fee (53.4%)	58.0	63.2	63.6	57.0	52.4	52.3	49.6	49.8	47.4	40.7
Subscription fee (1.4%)	3.1	1.2	1.3	.7	2.2	.8	1.2	1.5	1.1	.7
Performance-based fee (16%)	5.9	6.1	5.5	8.5	8.5	13.0	11.6	17.1	29.1	54.3
Other (9%)	13.1	9.7	9.0	8.6	7.3	8.1	7.6	8.1	7.8	10.1

Table is taken from Dean and Finke, 2012.

The ADV form also requires advisors to disclose the percentage of clients who are "high net worth individuals," defined by the SEC as having more than \$750,000 in savings and investable assets. If more than half of a firm's clients have investable assets greater than \$750,000, they are assumed to cater primarily to high net worth clients. Conversely, if more than half of a firm's clients are "individuals other than high net worth," they are assumed to cater primarily to moderate net worth clients. Since nearly all RIAs charge AUM fees, we separate firms into those who charge AUM only (21.6% of firms) and those who receive other forms of compensation.

TABLE 3. COMPENSATION METHOD & CLIENT NET WORTH

	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%
Hourly fee					
Yes	3,549	2,135,620***	350,067	35%***	44%***
No	3,854	18,881,711	935,267	46%	27%
Fixed fee					
Yes	3,953	6,110,363***	457,317	41%	38%***
No	3,450	16,288,453	658,139	41%	32%

***, **, and * are significant at the .001, .01, and .05 levels, respectively. Table is taken from Dean and Finke, 2012.

Results indicate that commission-compensated advisors have the highest proportion of low net worth clients while asset-fee compensated advisors had the highest proportion of high net worth clients (See Table 3.). Hourly and fixed fees were also associated with a larger proportion of low net worth clients.

Multivariate analysis controlling for firm assets under management, number of employees and other characteristics confirms the negative and monotonic relation between the use of commission compensation and average client account size. Hourly fees are also associated with catering to lower-wealth clients. After controlling for firm characteristics, it does not appear that AUM compensation is related to client account size. However, AUM compensation is associated with a reduced likelihood of providing financial planning services while commission, and to a greater extent hourly and fixed-fee compensation, results in an increased likelihood of providing financial planning services. This may be because AUM compensated advisors are more likely to provide portfolio management services rather than more comprehensive planning services. Since commission, hourly and fixed fees provide greater compensation per unit of time spent working with moderate wealth clients, particularly if an advisor provides time consuming but beneficial financial planning services, it is not surprising to find that RIAs using these forms of compensation have more lower net worth clients.

TABLE 4. PREDICTORS OF ADVISER COMPENSATION TYPE

	AUM Only	Commissions	Hourly Charges	Fixed Fees	Performance Based Fees	Other
Account Size Deciles (vs. 1st quintile)						
2nd	-.010	-.303*	.151	.234*	.014	-.323
3rd	.029	-.151	-.118	.216	-.098	-.415*
4th	.060	-.238	-.073	.100	.379	-.362*
5th	.033	-.499***	-.349**	-.022	.352	-.485**
6th	.147	-.710***	-.464***	.014	.823***	-.337
7th	.186	-.674***	-.504***	.040	.605**	-.362
8th	-.046	-.686***	-.773***	.167	.978***	-.256
9th	-.239	-.961***	-1.151***	.146	1.557***	-.278
10th	-.757***	-1.530***	-1.428***	-.083	2.390***	-.125
AUM quintiles (vs. 1st quintile)						
2nd	-.056	-.037	.169	.123	-.136	.092
3rd	-.072	-.227*	.037	.251**	-.116	.032
4th	-.063	-.420***	.018	.571***	-.288*	-.032
5th	-.332*	-.829***	-.052	.853***	-.215	-.132
Provide financial planning services	-2.225***	1.015***	2.469***	1.854***	-.879***	.584***
Provide portfolio management	.853***	-.441	-.303	.031	-.074	-1.059***
# of employees	-.148***	.484***	-.172***	.074*	.360***	.256***
Constant	-.932***	-1.869***	-.698**	-1.401***	-2.311***	-1.589***

***, **, and * are significant at the .001, .01, and .05 levels, respectively. Table is taken from Dean and Finke, 2012.

Among these compensation models that correlate with catering to middle or upper-middle class clients, commission compensation is by far the most popular. Investor surveys (for example a large survey of 7,800 households conducted in 2011 by Cerulli Associates) consistently find that consumers prefer commission compensation to fees. TCabral and Hoxby (2012) provide a model of consumer markets where some prices are more readily apparent and others are more opaque that may explain this preference. They find that taxpayers respond strongly to increases in property taxes, which tend to be more salient, and tend to ignore increases in income taxes, which are more opaque (since taxpayers don't have to write out a large check for that amount). It is likely that if advisors charging more salient hourly and plan fees competed with advisors compensation through commissions, consumers would reject the models that used more salient pricing. As is seen in the current marketplace, this will lead to a market where consumers often pay more for advising services than they would in a competitive market with more readily apparent pricing for advisory services. It is possible that simplified cost disclosure will increase the salience of advisor compensation and lead to greater price competition.

Industry Impact of a Fiduciary Standard

There is convincing empirical evidence that advisors regulated by the 1934 Securities Exchange Act under suitability requirements are more likely to cater to moderate wealth clients than advisors regulated by the 1940 Investment Advisers Act as fiduciaries. The broker-dealer industry (Headley, 2011) has argued that a fiduciary standard will increase liability risk and other costs, resulting in reduced supply of much-needed expert financial advice to average retail investors.

Broker-dealers may be subject to a stricter standard of care under state common law. In Finke and Langdon (2012), we identify four states that hold brokers to what resembles a fiduciary standard of care under the Investment Advisers Act - California, Missouri, South Dakota and South Carolina. For example, Missouri courts have held that "stockbrokers owe customers a fiduciary duty. This fiduciary duty includes at least these obligations: to manage the account as directed by the customer's needs and objectives, to inform of risks in particular investments, to refrain from self-dealing, to follow order instructions, to disclose any self-interest, to stay abreast of market changes, and to explain strategies" (State ex rel Paine Webber v. Voorhees, 1995). We also identify states where there is evidence of a limited fiduciary standard and states that appear to apply no fiduciary standards to broker-dealers.

Stricter fiduciary standards within state common law provide an opportunity to compare the potential impact of a shift from suitability to fiduciary standards on the broker-dealer industry. We conduct two experiments. In the first, we phone registered representatives of broker-dealers within states that have, and do not have, stricter fiduciary standards and ask them questions about their ability to meet the needs of moderate wealth clients. We then explore possible differences in the saturation rates of registered representatives with states sorted by fiduciary standards.

We find a remarkable similarity in responses between representatives in fiduciary and non-fiduciary states. The percentage of clients with wealth under \$75,000 is statistically equal, as is the perceived ability to recommend commission products. We find no evidence that regulation limits the range of products or the ability to meet client needs. There is some evidence, although not statistically significant, that compliance costs are higher in fiduciary states. We also find no evidence that stricter fiduciary standards impact the saturation rates of registered representatives with states that have a stricter fiduciary standard.

If the application of fiduciary standards to broker-dealers improves retail investor welfare at the expense of the industry, it is natural that there will be industry opposition even if the policy is social welfare maximizing. In order to test whether dire predictions of reduced supply by the industry come to fruition after a substantial change in policy, Anagol, Marisetty, Sane and Venugopal (2013) compare whether changes in mutual fund distribution fees in India significantly reduced the supply of these funds and find no evidence to suggest that rule changes had an impact on supply of funds.

The majority of retail investor welfare loss from suitability standards arise from self-serving recommendations of products that are more expensive than the ideal, and reduced incentives to both create more efficient financial products and to invest in the knowledge required to make high quality recommendations. To the extent that fiduciary standards help align the interests of the agent and retail investor, it is possible that a combination of improved price disclosure and more effective disincentives to make self-serving recommendations will have little impact on the supply of advice while improving investor outcomes.

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