The Market for Retirement Financial Advice

EDITED BY

Olivia S. Mitchell
and Kent Smetters

OXFORD
UNIVERSITY PRESS

OXFORD
UNIVERSITY PRESS

Great Clarendon Street, Oxford, OX2 6DP,
United Kingdom

Oxford University Press is a department of the University of Oxford.
It furthers the University's objective of excellence in research, scholarship,
and education by publishing worldwide. Oxford is a registered trade mark of
Oxford University Press in the UK and in certain other countries

First Edition published in 2013

Impression: 1

Published in the United States of America by Oxford University Press
198 Madison Avenue, New York, NY 10016, United States of America

British Library Cataloguing in Publication Data
Data available

Library of Congress Cataloging in Publication Data
Data available

ISBN 978–0–19–968377–2

Printed in Great Britain by
CPI Group (UK) Ltd, Croydon, CR0 4YY

Contents

Chapter 2

The Market for Financial Advisers

John A. Turner and Dana M. Muir

Many individuals lack basic financial knowledge (e.g., McCarthy and Turner, 2000; Lusardi and Mitchell, 2006), and hence they would likely benefit from financial advice. Pension plan sponsors also need financial advice when choosing what types of plans to offer, setting up pension plans, choosing investment options for 401(k) plans (by far the most common type of employer-provided plan), managing the investments of defined benefit (DB) plans, establishing pension plans for executives, and hiring service providers. This chapter focuses on financial advice related to preparing for retirement, considering advice provided to both individuals and pension plan sponsors.

We begin by providing background on ways that advisers interact with their clients, and on the scope of their investment advice. Second, we discuss the types of firms providing advice and requirements for some of the certifications that financial advisers use. These certifications provide individuals and plan sponsors a way to assess adviser qualifications. Third, we investigate issues related to the level and disclosure of fees financial advisers charge. Next, we explain how the structure and level of advisory fees may result in conflicts of interest that can affect the quality of advice provided. Then we outline how the US legal and regulatory environments are evolving in response to conflicts of interest and investor confusion about standards of care identified in several studies as being potentially problematic. Finally, conclusions appear in the final section.[1]

Financial advice for individuals

First we discuss the ways in which financial advice can be provided and topics covered in financial advice.

How financial advice can be provided for managing investments

Financial advisers can provide clients assistance with their investments by offering education, decision support, advice, or marketing information;

alternatively, they can manage the individual's investments themselves. Decision support is education targeted to help a client reach a decision. Marketing information may appear to the client to be unbiased advice, but it is designed to sell a product.

Many advisers also assist their clients in carrying out their advice. If an adviser provides financial management, he makes investment decisions and carries them out without involving the individual investor in the decision. Some 401(k) plans offer employees managed accounts, where the individual's assets are professionally managed. This option is also available for non-pension accounts. Advice and marketing materials of some service providers encourage clients to have professionally managed accounts, which tend to generate higher ongoing fees. We focus in this study on investment advice, and not asset management.

An alternative to a financial adviser is advice generated by financial planning software, some of which is available for free over the Internet (Turner and Witte, 2009). A further alternative to a financial adviser, at least for investment advice, is a target date investment fund, in which the asset mix of a diversified portfolio is automatically adjusted to take into account a shortening investment horizon as the client's expected retirement date approaches.

We focus here on advice that includes interaction with a financial adviser. The financial adviser provides advice as to financial decisions, and the individual decides whether to follow the advice. An adviser can provide advice through a variety of methods, including online, by telephone, at call centers or help desks, at company offices, at group seminars, or in one-on-one sessions.

Topics covered and topics often overlooked

The retirement-related topics on which individuals may need financial advice are far broader than investments. They can include when to leave work, when to claim Social Security benefits; and for those with a pension or personal savings, whether to roll over a 401(k) plan to an Individual Retirement Account (IRA), how to liquidate assets in retirement, and whether to purchase an annuity.

Some advisers focus only on investments, and do not provide advice on some of the other decisions individuals must make concerning retirement. For example, some advisory companies focusing on investments note that they do not provide tax or legal advice (e.g., T. Rowe Price, 2011*a*, 2011*b*). Nevertheless, despite the disclaimer provided for legal reasons, some do discuss tax considerations related to selecting investments and deciding in what order to sell investments in retirement.

A survey of free financial planning software available online found that most programs do not provide advice as to purchasing an annuity, even when confronted with a scenario rigged to make purchasing an annuity desirable (Turner, 2010). One mutual fund company we contacted indicated that few of its clients sought advice as to how to take pension payouts. For that reason, the firm's decision to not provide advice concerning annuities was partly demand-driven. Another reason it cited is that financial experts do not have a standard methodology for determining how much a client should annuitize. By contrast, life insurance companies are expected to advise concerning purchase of an annuity.

One reason some financial advisers have not recommended annuities in the past is that annuitization would reduce their assets under management, and thus their fees. More recently, insurers have introduced variable annuities that allow the adviser to still manage the asset base and capture management fees. For instance, in some variable annuities, the account is typically invested in mutual funds chosen by the client during the accumulation phase. During the payout phase, generally the client has the choice of receiving a fixed payout, or having a payout that varies depending on the investment performance of the underlying assets.

Advisers' employers and credentials

Financial advisers differ in the types of companies they work for and in the certifications they obtain.

Companies providing financial advice

Companies providing financial advice include banks and trust companies (e.g., UBS), mutual fund companies (e.g., Vanguard), financial advisory companies (e.g., Veritat), brokerage companies (e.g., TD Ameritrade), and insurance companies (e.g., MetLife). Accounting and law firms also provide financial advice. With financial companies acquiring each other, facilitated by more permissive regulation, the distinctions as to the nature of companies are increasingly blurred (e.g., Bank of America Merrill Lynch, 2011). In 2010, 19 percent of investment advisory firms that provided financial planning services also provided brokerage services, while 27 percent also sold insurance (GAO, 2011*b*).

Some financial services companies provide only advice, while others only investment management. Some advisers offer the option of advice only or investment management (TD Ameritrade, 2011). Financial Engines is a company that began by providing financial advice to 401(k) plan participants through employers sponsoring 401(k) plans. From its early experience it observed that often its clients did not take the steps necessary to follow its advice, so it now primarily manages 401(k) accounts, for which it accepts fiduciary responsibility (Financial Engines, 2011). By contrast, many companies that provide financial advice to plan sponsors do not accept fiduciary responsibility (Simon, 2004). Guided Choice (2011) and Bank of America Merrill Lynch (2011) provide advice to 401(k) participants through arrangements with plan sponsors. Using a different business model, Smart401(k) (2011) provides investment advice directly to individual 401(k) plan participants. On the websites of these three companies, there is no indication that they accept fiduciary responsibility.

Insurance companies may also provide financial advice relating to the marketing of various insurance products, including variable annuities and other payout products. The advice they provide can also go beyond these traditional areas: for example, MetLife Securities, Inc., a subsidiary of MetLife (the holding company for Metropolitan Life Insurance Company), offers traditional financial planning assistance, including fee-based financial planning (MetLife, 2011). An insurance agent who works for an insurance company is referred to as a 'captive agent.' Independent agents who sell the products of multiple companies are called insurance brokers. In both cases, compensation is often based on commissions (Kolakowski, 2011).

As a general matter, advisory firms must register as investment advisers with the Securities and Exchange Commission (SEC), which is an agency of the federal government, or with a state government, depending on the amount of assets receiving continuous and regular supervisory or management services (Assets Under Management, or AUM). The minimum amount for required SEC registration as of 2011 is $100 million (SEC, 2011*d*). Firms with AUM of below $100 million must register with state government regulators.

An advisory firm that does not meet the minimum AUM test for SEC purposes may still register with the SEC instead of state regulators if it is a 'pension consultant' that provides investment advice to employee benefit plans or a plan fiduciary on a minimum aggregate asset value. That minimum increased in 2011 to $200 million. The SEC's rationale is that pension consultants who provide various services regarding large amounts of plan assets may have an effect on national markets, even if they do not technically have AUM (SEC, 2011*e*: 42,959).

Professional certifications of financial advisers

BrightScope, Inc. (2011), a company started in 2009 that analyzes 401(k) plans, argues that 401(k) plan sponsors need more information about investment advisers than they currently have. Its website provides information on about 450,000 investment advisers, including their experience and employment history. The database is slated to over a million names, once advisers registered with individual states are included (Bliman, 2011).

In addition, the Financial Industry Regulatory Authority (FINRA) maintains a database on 1.3 million current and former stock brokers registered with FINRA, and 17,000 current and former brokerage firms registered with FINRA (FINRA, 2011*b*). FINRA is a private-sector self-regulatory organization for broker-dealers. Private-sector self-regulation of brokerage firms is generally not found in other countries, with the government having sole regulatory responsibility.

The term 'financial adviser' is not regulated by law, and financial advisers have a wide range of professional backgrounds. They can be accountants, attorneys, estate planners, insurance agents, stock brokers, and investment advisers (Certified Financial Planner Board, 2011*c*). FINRA (2011*a*) warns consumers that the terms *financial analyst, financial adviser, financial consultant, financial planner, investment consultant,* and *wealth manager* are generic job titles that are generally not regulated. That is, these titles do not necessarily indicate any given level of expertise or credential.

The requirements for certifications used by financial advisers vary considerably. FINRA (2011*a*) lists over 100 professional designations for financial advisers. While some designations require examinations and continuing education, others merely signify that the certificate holder has paid membership dues (GAO, 2011*b*).[2] Certifications that financial advisers use include Certified Financial Planner, Chartered Financial Analyst, Chartered Investment Counselor, Personal Financial Specialist, Chartered Financial Consultant, Chartered Life Underwriter, and Certified Employee Benefit Specialist. Some financial planners obtain none of these certifications but instead have educational backgrounds as attorneys, accountants, economists, or MBAs.

Certified Financial Planner

The Certified Financial Planner (CFP) certification is administered by a private-sector organization, the CFP Board. In dealing with clients, CFPs agree to follow the principles of confidentiality, integrity, objectivity, competence, fairness, professionalism, and diligence (Certified Financial Planner Board, 2011*a*). CFPs must have at least a Bachelor's degree and have taken specific courses, either at an academic institution or proprietary courses approved by the CFP Board that cover topics on the CFP certification examination. Having a Ph.D. in Economics automatically meets the education requirement, but it would generally not adequately prepare someone to take the examination. Beginning in 2012, the education requirement includes completion of a financial plan development course approved by the CFP Board.

Once the education requirement is met, a candidate can sit for the CFP certification examination, which takes 10 hours over two days; the exam fee is $595. Topics covered include insurance planning and risk management, employee benefits planning, investment planning, income tax planning, retirement planning, and estate planning. Having passed the examination, the candidate must satisfy ethics requirements concerning past illegal activity and agree to adhere to ethical standards in the future. The candidate must also have at least three years of qualifying work experience. Once certified, the CFP must take 30 hours of continuing education every two years, including 2 hours on professional conduct.

Chartered Financial Analyst

The Chartered Financial Analyst Institute has more than 100,000 members worldwide, making it the world's largest association of investment professionals (Chartered Financial Analyst Institute, 2011). The Chartered Financial Analyst (CFA) educational program requires passing three examinations for which candidates spend on average 300 hours preparing for each. Candidates can complete the program in eighteen months, but, on average, take four years. To enter the education program, an individual must have a Bachelor's degree or be in the final year of earning that degree, or have four years of qualified professional work experience.

The CFA program focuses on corporate finance and investments, including derivatives and alternative investments such as real estate, commodities, and hedge funds. By comparison, the CFP program includes those issues and also covers financial planning issues more broadly. For example, the CFP educational program has a section on Social Security benefits not covered in the CFA program (Certified Financial Planner Board, 2011*b*). Similarly, annuities are discussed in the CFP program, but they are not covered in the syllabus for the CFA program.

Chartered Investment Counselor

The Investment Adviser Association (IAA) has established the Chartered Investment Counselor (CIC) program (IAA, 2011). A CIC must be a CFA and meet additional requirements established by the IAA, including being employed by an IAA member firm and having five years of qualifying experience.

Personal Financial Specialist

The Personal Financial Specialist (PFS) program enables Certified Public Accountants (CPAs) to receive professional recognition for their expertise in personal financial planning (American Institute of CPAs, 2011). CPA is the title for accountants who have passed a qualifying examination and have met state requirements concerning education and experience. A PFS must be a member of the American Institute of Certified Public Accountants (AICPA). More than 3,000 CPAs have the PFS certification, or about 1 percent of the membership of the AICPA (Drucker, 2005). According to the AICPA, the PFS's knowledge about tax issues distinguishes this credential from others. Nonetheless, many CPAs who do not have the designation engage in aspects of providing financial advice (Drucker, 2005).

The PFS examination takes over 7 hours. The PFS must have at least two years of full-time business or teaching experience related to financial planning, and must complete at least 80 hours of personal financial education. The PFS must pass the PFS examination. The cost of the examination is $400 for AICPA members.

Chartered Financial Consultant

The certifications discussed thus far are awarded by industry or professional groups, but some certifications are awarded by academic institutions. One example is the Chartered Financial Consultant (ChFC) program is offered through the American College in Bryn Mawr, Pennsylvania (The American College, 2011*a*). The ChFC is trained to meet the financial planning needs of individuals, professionals, and small business owners. The ChFC must complete nine courses—seven required and two elective. The seven required courses include Fundamentals of Insurance Planning and Fundamentals of Estate Planning. The cost of admission to the program is $135, and the cost per course is $599. According to the American College, the ChFC program has more extensive education requirements than any other financial planning credential. The education program can be done through self-study or through attending live webinars.

Chartered Life Underwriter

The Chartered Life Underwriter (CLU) certification is also offered by the American College (The American College, 2011*b*). The CLU program participant must take five required courses and three elective courses, some of which overlap with the ChFC courses. The cost of each course is approximately $600. Topics include life insurance law, insurance and estate planning, insurance for business owners and professionals, and retirement planning. Both the ChFC and CLU programs require three years of full-time professional experience within the past five years. Both require adherence to an ethical code.

Other professional designations include the Certified Fund Specialist (CFS), Certified Investment Management Analyst (CIMA), and actuarial designations such as Fellow of the Society of Actuaries (FSA).

Fees for financial advice

This section discusses the types of fees charged, issues related to the clarity and usefulness of the disclosure of fees to individuals, fees charged to individuals, fees charged to plan sponsors, and the compensation received by financial advisers.

Types of fees

Financial advisers charge fees in various ways (Anspach, 2011*a*; Maxey, 2011).

1. They charge a fee as a percent of the client's account balance or the amount of assets they help manage. The larger the minimum account balance and the larger the account, the lower fee percentages tend to be, due to economies of scale. This is the traditional and most common approach, accounting for 85 percent of the revenues of advisory firms in 2010 (Maxey, 2011).

This approach not only provides incentives for the adviser to attempt to increase the individual's asset base, but it may also encourage too much risk taking. In addition, the adviser may have an incentive to not let money exit the asset under management, such as purchasing an annuity or insurance, paying down a mortgage, or drawing down assets to postpone taking Social Security benefits (Maxey, 2011). The adviser may also have an incentive to make moves that bring money into the asset base, such as rolling over a 401(k) plan into an IRA.

Finally, fees based on AUM may give rise to what are known as 'reverse churning' claims. In churning claims, clients accuse brokers of changing their investments in order to increase commissions payable to the broker. Reverse churning claims occur when advisers allegedly ignore accounts by failing to properly monitor or reallocate investments, because the adviser's compensation is based on AUM.

2. Advisers may receive commissions on insurance or financial products they sell to their clients. This compensation may be entirely based on sales commissions, or partly on referral fees paid by third parties. To the client, the advice may appear to be free, but in actuality the client is paying through the fees that third parties charge for managing the investments, conducting trades, etc. This approach has the problem that advisers may have an incentive to buy and sell products when they get a commission for trades (Maxey, 2011).

3. Many advisers collect both fees and commissions, acting under the descriptor of fee-based adviser versus the fee-only adviser. An adviser receiving both fees from the client and commissions from third parties may rebate some or all of the commissions received to the client through a reduction in fees. This arrangement is called a fee offset.

4. Advisers may charge an hourly rate for their time spent advising clients, or a flat fee for a specific project.

5. Advisers may charge a quarterly or annual retainer fee if the client has an ongoing need for advice, or they may charge a fixed annual maintenance fee.

6. Advisers may charge a fee based on the client's income, or based on the client's net worth (not just their portfolio holdings).

The SEC also lists two other ways financial advisers might charge fees: (*a*) subscription fees for a newsletter or periodical; and (*b*) performance-based fees tied to the rate of return the client receives on his investments. Performance-based fees can only be charged to wealthy clients.

Advisers who charge fees as a percentage of account balances generally establish minimum fee levels by requiring that their clients have a minimum amount of assets to invest; such asset minimums range from $20,000 to $500,000. For example, Merrill Lynch has a minimum of $250,000 in investable assets for one class of advice, while its Merrill Edge Advisory Center is for people with $20,000 to $250,000 in assets to invest and for whom a lower level of service is provided (Merrill Edge, 2011). Vanguard's financial advisers use a minimum of $500,000 (Vanguard, 2011*a*). The minimum asset requirements for clients of a number of companies are high compared to the average households' stock holdings. The median holdings of stock outside retirement plans by households aged 45–54 with stock was $45,000 in 2007 (Bucks et al., 2009).

Different fee structures may be preferable to different types of investors. For example, an hourly fee or a flat fee would presumably be preferable to individuals with insufficient assets to meet the minimums set by advisers charging asset-based fees (Maxey, 2011).

Disclosure of advisory fees to individuals

Fee levels charged by financial advisers vary widely, but few companies compete based on fees when marketing their services. Financial advisers, even low-cost ones, generally do not highlight fee information on their websites. Generally, websites do not contain information on fees, or if they do, that information can only be obtained with effort. For example, the main pages at the Vanguard (2011*b*) financial advice website do not report information as to asset management. This information for asset management can be obtained with sufficient diligence by following links, but fees for advice are apparently not disclosed on the website. (Vanguard does mention on the first webpage for advice that it provides advice at low cost.) GuidedChoice (2011) indicates on its website that it favors transparency in fees, but it does not provide fee information. Merrill Lynch (2010) never mentions fees on its Global Wealth & Investment Management website. While it might be expected that footnotes would contain technical information of interest only to specialists, TD Ameritrade discloses its fee structure for account management in small print in the third paragraph of a footnote on its website (TD Ameritrade, 2011).

Individuals can obtain information about fees by going to the website of the SEC and examining disclosure forms, called ADV forms, for different advisory companies. Yet few individuals are likely to be aware of this source of information, and even fewer use it. As part of the requirement that advisory firms file an ADV form, the SEC requires that registered investment advisers provide a written disclosure statement (called a brochure) to clients and prospective clients. Disclosure includes information concerning fees. It also requires advisers to make disclosures as fiduciaries, including material facts about the advisory relationship and any conflicts of interest.

Fees for investment advice to individual investors are tax deductible, but fees for investment management are not deductible. Tax deductible financial advisory fees are disclosed on the Internal Revenue Service (taxing authority) IRS Form 1099 provided to clients by their financial services companies after the calendar year has ended; that disclosure does not include management fees and transaction costs. Transaction costs resulting from financial advice involving active management, which are fees the participant pays, are rarely, if ever, disclosed to clients (Turner and Witte, 2008). Advisers acting as brokers are not required to disclose commissions at the point of sale (Maxey, 2011). That information is disclosed later, when the individual receives the confirmation of the transaction.

An issue related to the disclosure of fees is whether such disclosure is used by pension participants, or whether the added cost of disclosure fails to benefit participants. The effects of the disclosure may depend for some investors on the format of the disclosure. Hastings and Mitchell (2011) show that people with low levels of financial literacy are more affected by the formats in which fee information is disclosed, compared to people with high levels of financial literacy who are more likely to understand the information whatever the format used.

Level of advisory fees charged to individuals

In practice, the level of advisory fees varies widely. For example, T. Rowe Price (2011*a*) offered financial advice in 2011 to its clients at a flat fee of $250, with the fee waived for clients with $500,000 or more invested, or who made a one-time purchase of $100,000 or more.

Motley Fool (2011) has an innovative way of providing low-cost financial advice that involves greater participation by the client than is generally true. This program, called the TMF Money Advisor, charged a flat annual fee of $195 in 2011. Part of the cost of providing individual financial advice is the cost of gathering information from the individual and inputting that information into a computer model. Motley Fool's clients input their own financial information into an online computer model, taking about an hour to do so (not including the time required to gather the information). Subsequently, a financial adviser at a call center can look at the information provided online and discuss a computer-generated financial plan with the clients.

One company charges fees at the rate of 1 percent of the individual's Adjusted Gross Income plus 0.5 percent of their net worth (excluding closely held businesses), with the second fee declining to 0.25 percent and then 0.1 percent as net worth grows (Maxey, 2011).

Hourly rates charged by advisers vary widely (Anspach, 2011*a*), with the average hourly fee starting at around $175 an hour in 2011 (Motley Fool, 2011). In practice, we found that company websites rarely reported hourly rates; instead, companies generally require clients to call to find out their hourly rates.

New Means Financial Planning (2011) is a fee-only service in New Hampshire that does provide detailed information about its fees. A financial consultation for clients in their 20s and early 30s costs $800 to $1,000. A typical fee to assess how much life insurance and other insurance a person needs ranges from $600 to $1,000. Advice on investments in a 401(k) plan ranges between $400 and $800 per plan. An assessment of the person's entire portfolio ranges from $1,000 to $2,200. Advice on retirement planning ranges from $1,000 to $2,000. A comprehensive financial plan costs between $2,200 and $4,400. Alternatively, a client can receive advisory services at an hourly rate of $200 (in 2011 dollars).

Advisers who charge fees as a percentage of assets may have formulas that take several factors into account. For example, as well as the amount of assets, they may take into account the complexity of the client's investment strategy, the frequency of meetings or investment reviews, and the extent of trading activity.

Some financial advisers charge insurance companies for recommending purchase of an annuity. For example, Schwab (2011*a*) could recommend purchase of an annuity, but only from insurance companies that compensate Schwab for its role as agent for the sale and servicing of annuity contracts. Generally, Schwab's compensation is based on the amount to be annuitized and the type of annuity. A fixed deferred annuity in 2011 had a 1.50 percent commission paid at the time of purchase, with a 0.65 percent trail commission, paid annually. A trail commission offsets the disincentive to Schwab of removing assets from the base of AUM. A fixed immediate annuity has a 3.50 percent commission paid at time of purchase. These costs are in addition to the charges of the insurance company, and they presumably are passed on to the client.

Level of advisory fees charged to plan sponsors

Plan sponsors often hire financial advisers to help them make decisions concerning the pension plans they sponsor. For 401(k) plans, these decisions relate to the investment options they offer participants, and also to financial education and advice provided to participants. For DB plans, decisions tend to relate to the selection of investments for the pension fund.

No unique source exists for examining fees charged to pension plan sponsors. Edelman Financial Services establishes 401(k) plans for companies for a one-time setup fee that is not disclosed at its website. It will then manage the 401(k) plan, including providing advice to participants for a flat annual fee (also not disclosed at its website; Edelman Financial Services, 2011). To obtain information about those fees, a plan sponsor must directly contact the firm, which makes it more costly in terms of time and effort to compare fees.

Compensation received by financial advisers

Users of financial advice need to understand the fees they pay directly to their adviser or adviser's employer, as well as how their adviser is compensated, including indirect effects on his compensation such as compensation from third parties. Compensation from third parties can also affect the advice that the adviser provides. The US Department of Labor (2011) specifies that compensation a financial adviser receives can include 'commissions, salary, bonuses, awards, promotions, or other things of value,' as well as fees. 'Other things of value' include trips and gifts. The precise level of compensation the adviser receives may be difficult to determine when the adviser receives commissions for products he sells, as well as fees.

Advisers who work independently, including those who sell long-term care insurance, may be paid entirely through commissions they receive for products they sell, or may receive fees, or both. Regarding advisers who work for companies, most companies do not explain how their advisers are compensated, and it can be difficult to obtain information on how compensation by third parties affects the compensation of financial advisers employed by a firm. For example, Benjamin F. Edwards & Co. discloses that it receives third-party payments but indicates that those payments do not directly affect the compensation of employees acting as financial consultants. It discloses further that 'it is possible, through various compensation arrangements, that financial consultants may indirectly benefit from these payments' (Benjamin F. Edwards & Co., 2011), but the firm does not disclose on its website exactly how third-party payments affect a consultant's compensation.

Some financial services companies offer financial advisers options for employment and compensation. Under one option, the advisers are affiliated with the company, but they remain responsible for establishing their office. Under the second option, agents are employees of the company which provides them full office support. Under both options, compensation is based on the business they generate. Agents receive a smaller percentage of their fees and commissions under the second option than the first option.

Some financial advisers also pay CPAs and other professionals referral fees. For example, CPAs may receive referral fees when they refer a client to a financial adviser, ranging from 10–20 percent, to as much as 40 percent, of the fee charged by the adviser (Drucker, 2005). In addition, independent financial advisers recommended by Charles Schwab pay Schwab a fee for referrals (Schwab, 2011*a*). These fees are at least partly passed on to clients.

Issues concerning financial advice provided to individuals

After identifying a qualified financial adviser with expertise that meets their needs, the consumer receiving financial advice may still encounter difficulties. For example, people may not understand the information or advice they receive, and such problems may be age-related (Karp and Wilson, 2011). In addition, people may receive biased advice that may not be in their best interest when they have difficulty evaluating the quality of the advice received. According to a survey by the Investor Protection Trust, about 20 percent of adults aged 65 or older report having 'been taken advantage of financially in terms of an inappropriate investment, unreasonably high fees for financial services, or outright fraud' (Infogroup/ORC, 2010). Other problems they may encounter are inaccurate information, such as use of overly optimistic rate of return assumptions in financial projections (Turner and Witte, 2009), or lack of advice on certain topics, such as annuitization (Turner, 2010).

Next we turn to problems in understanding advice caused by terminology, advice relating to the marketing of products where a fiduciary duty does not apply, and problems in quality of advice caused by conflicts of interest that advisers may have.

Terminology

Financial advice can be hard to understand because of the terminology advisers use: for instance, consumers may be unclear as to the difference between a fee and a commission, or know what a load is. A fee is a payment the adviser receives from the client for providing advice. A commission is a payment the adviser receives for selling a financial product. A load is the commission investors pay when they purchase retail mutual funds. Other examples include 'wrap fees' and 'discretionary versus non-discretionary assets.' A wrap fee is a fee charged for providing a bundle of services, without breaking out the charges for the different components of the bundle. Discretionary assets are assets for which the client has delegated responsibility for management to the management company. The fine print relating to financial advice is often difficult to comprehend. As an example, prospectuses may mention 12b-1 fees, with no explanation as to what they are. These fees are marketing or distribution fees charged by mutual funds.

Advice related to marketing where a fiduciary duty does not apply

When marketing products to consumers, financial service providers often do not have a duty to provide advice in the best interest of the client (GAO, 2011*a*). For example, many insurance companies market variable annuities. These are investment products until retirement, at which point the investor has the option of converting them to annuities, with one option being converting them to variable annuities whose payouts vary depending on the investment performance of the underlying assets. One firm suggests that variable annuities offer for market appreciation with tax-deferred accumulation and future income. The SEC, however, suggests that many people may be better off investing the maximum amounts in their IRA and 401(k) plans before purchasing variable annuities (SEC, 2011*f*).

Conflicts of interest can arise with financial advisers at several points in the 401(k) decision-making process. For instance, plan participants may be affected by conflicts of interest when sponsors receive advice as to what investment options to include. This determines the choice set, given participation in the plan. In recent court cases, some 401(k) plan participants allege they lost millions of dollars collectively because of investment options with high fees that benefited their plans' investment managers. Participants may pay too much in fees when low-fee options are not available (GAO, 2011*a*).

Moreover, financial advisers may encourage pension participants to not contribute more than the amount necessary to receive the full employer match, and instead to put extra savings into financial products outside the plan if the adviser receives commissions on those products (Pettus and Kesmodel, 2010).

Plan participants may also be affected by conflicts of interest of advisers when they select funds from among the investment options available to them. Some participants may not distinguish between financial education, where the provider does not have a fiduciary obligation, and financial advice, where the provider may have a fiduciary obligation. Participants may become confused, for example, if advisers highlight only the products of the company providing the education (GAO, 2011*a*).

Sometimes a financial adviser may fail to explain the value of selecting low-fee funds, for instance when the adviser is connected to a mutual fund family, so he may recommend only those funds without mentioning fees. The potential magnitude of this conflict can be assessed from data on expense ratios. In 2010, according to the Investment Company Institute (ICI), the asset-weighted expense ratio for stock mutual funds invested in 401(k) plans was 71 basis points (ICI, 2011*a*). This figure represents the result of decisions by plan sponsors as to what funds to offer, as well as decisions by plan participants as to what funds to choose. This figure is higher than the expense ratios for institutional low-cost stock index mutual funds. While 401(k) participants may receive more services than do individual investors, which raises costs, employers could negotiate for institutional rates to lower costs.

Participants may also be adversely affected by conflicts of interest by advisers when participants leave the companies sponsoring their 401(k) plans. That is, some individuals may encounter biased advice when considering whether to roll over a 401(k) plan to an IRA. Research suggests that providers may gain higher fees from consumers moving their money to investments outside 401(k) plans (GAO, 2011*a*). Mutual fund companies and insurers encourage individuals to roll over their 401(k) plan accounts from former employers into IRAs. This may not be in the best interests of individuals, due to possibly paying higher fees. Individuals may also encounter advice to roll over their 401(k) accounts, even when not seeking advice, since mutual funds advertise their advice on television and in other media. The US Department of Labor (2011) currently does not consider this type of advice to be investment advice, and thus it is not covered by fiduciary standards. Also, individuals may be affected by conflicts of interest when they seek advice as to the investments of their IRAs.

The potential magnitude of the costs resulting from advice concerning rollovers from 401(k) plans to IRAs is large. Between 1998 and 2007, more than 80 percent of funds contributed to IRAs came from rollovers from other plans, primarily 401(k) plans but also including other defined contribution (DC) plans and DB plans (GAO, 2011*b*). In 2010, IRAs held $4.5 trillion in assets versus $2.9 trillion in 401(k) plans (Investment Company Institute, 2011*b*); accordingly, IRA rollovers are one of the main drivers of the structure of the US retirement income system. IRA account holders typically pay higher fees than 401(k) plan participants—about 25 to 30 basis points a year higher (GAO, 2011*a*).

Inertia would tend to cause 401(k) participants to keep their 401(k) accounts with their former employers where sensible. Inertia has been cited as a powerful force regarding employee contributions to 401(k) plans (Choi et al., 2004). The force of inertia, however, has been overcome with respect to rollovers in a major way. One explanation for this phenomenon may be that individuals receive advice from mutual funds and other financial service providers, encouraging them to roll over their 401(k) accounts to earn higher fees.

Conflicts of interest affecting individual investors

For individuals holding non-qualified investments (investments not benefiting from the preferential tax treatment received by pensions), the potential for conflicts of interest depends on the choice of investments. Due to how advisers are compensated, some may provide biased advice to individuals concerning the choices between mutual funds and individual stocks; for example, some advisers are paid by mutual funds that their clients select, biasing them in favor of those funds. Others may receive higher compensation for recommending individual stocks in a portfolio they manage than for recommending low-cost mutual funds. At Schwab, advisers receive 0.0028 percent of assets as a fee for funds invested in individual stocks, 0.0350 percent of assets for money invested in mutual funds, 0.0595 percent for assets invested in Schwab-managed portfolios, and 0.0770 percent for assets enrolled in Schwab Private Client where the adviser provides ongoing services (Schwab, 2011*b*). At Ameriprise (2011), some employees receive higher compensation if they recommend and sell affiliated mutual funds, than if they sell mutual funds not affiliated with Ameriprise. Conflicts of interest also arise when a firm underwriting an IPO (Initial Public Offering of stock) also provides advice to retail clients, encouraging them to purchase the stock (Loewenstein et al., 2011).

Financial advisers charging ongoing fees may also be biased toward recommending active management associated with higher transaction costs, rather than passive management in index funds, so as to boost the commissions from the broker-dealer that the adviser receives (GAO, 2011*a*). Schwab (2011*b*) compensates some advisers based on the clients increasing the amount of trading that they do.

Issues affecting the quality of financial advice provided to plan sponsors

Conflicts of interest affecting the quality of advice are also relevant to plan sponsors, because some mutual funds pay advisers who recommend funds. These payments can create a conflict of interest, if an adviser directly or indirectly receives compensation from marketing certain funds. Furthermore, low-cost funds tend not to offer such payments. For example, some mutual funds offer share classes with no revenue sharing and lower expense ratios, alongside share classes with revenue sharing and higher expense ratios (Reish and Ashton, 2011). Revenue sharing occurs when a mutual fund pays an adviser to recommend the fund (Moon, 2004). The payments may be characterized as paying for expenses relating to selling the fund. At least one service provider—Securion—deals with the issue of revenue sharing by passing on all revenue sharing to the plan, crediting the amounts to the individual accounts that generated the revenue sharing (Reish and Ashton, 2011).

The amount of revenue-sharing payments advisers receive varies considerably. One study found that payments range from 5 to 125 basis points annually (GAO, 2011*b*). Employee Retirement Income Security Act (ERISA; US private pension law) requires pension plan sponsors to consider conflicts of interest when selecting service providers (GAO, 2011*a*). For example, an investment adviser may purposely not negotiate for the lowest transaction fees for plan participants for buying and selling shares. As a result, the broker-dealer would pay the investment adviser out of these higher fees (GAO, 2011*a*).

Evolving legal and regulatory issues

The US legal system has struggled in recent years with the regulation of financial advisers, including regulation of the services they provide to employee benefit plans sponsored by private-sector employers. The continuing evolution of the legal and regulatory issues may be attributed to a number of factors. The increase in assets held in 401(k)-style plans and

IRAs has drawn the attention of regulators to the importance of investment selection in retirement security (EBSA, 2011). Behavioral economists have contributed to the debate by investigating questions such as whether investors benefit from an expanded set of investment alternatives (Benartzi and Thaler, 2002). Among the research mandated by Congress after the financial crisis was a study of the regulation of financial planners by the Government Accountability Office (GAO), an independent agency of the federal government, and a study of the regulation of investment advisers and broker-dealers by the Staff of the SEC (GAO, 2011*b*; SEC Staff, 2011*b*). The SEC is responsible for regulation of the US capital markets and investor protection. Next we explain legal issues as they relate to financial advisers, provide some background on the history of those issues, and update the status of regulatory efforts.

Conflicts of interest

The primary legal issues regarding investment advisers are grounded in identification of the conflicts of interest that may exist in the provision of investment advice and how best to mitigate such conflicts in ways that are understandable to investors. The SEC is concerned with these issues as part of its general mandate to protect investors and specifically in its interpretation and enforcement of the Investment Advisers Act of 1940 (Advisers Act). The Employee Benefits Security Administration (EBSA) of the Department of Labor has an overlapping regulatory interest because of its mandate to regulate private-sector employee benefit plans, such as 401(k) plans, including regulation of the entities that provide services to those plans and to the employees who participate in the plans. As discussed below, the overlapping regulatory authority of the SEC and EBSA increases the complexity of regulatory efforts. That complexity is increased further through the involvement of the self-regulatory agency, FINRA, which regulates broker-dealers including broker-dealers who provide investment advice, and various state agencies that regulate advisers who engage in securities-related transactions and sales of insurance products.

The US legal system uses three methods to mitigate conflicts of interest. Those three methods are: (*a*) requiring disclosure, (*b*) prohibiting specified actions, and (*c*) subjecting actions or actors to fiduciary duties. Each of these methods is used in the context of investment advice. Turning to disclosure first, the relevant legal standard may require that an actor such as an investment adviser disclose its conflicts of interest so that the client can consider the existence of the conflicts when selecting an investment adviser and in evaluating its recommendations. For advisers who are fiduciaries, disclosure of conflicts of interest typically is part of the adviser's general fiduciary duties.

Specific disclosure requirements sometimes go beyond the general fiduciary obligations. For example, advisers who register with the SEC must disclose conflicts of interest in their public filings (SEC Staff, 2011*b*: 19, 22). Federal securities laws require broker-dealers to register with the SEC and prohibit broker-dealers from engaging in fraudulent actions. The prohibition on fraud results in an implied obligation to disclose significant conflicts of interest. FINRA rules require broker-dealers to disclose conflicts of interest in certain situations but the FINRA staff does not believe that there is a general requirement that broker-dealers disclose their conflicts of interest at the beginning of a client relationship or transaction (GAO, 2011*b*).

The second method of mitigating conflicts of interest—prohibition—applies to some investment advice provided regarding benefit plan assets through ERISA's ban on 'prohibited transactions.' Prohibited transactions include transactions where a fiduciary to a plan or an affiliate of the fiduciary is compensated for providing investment advice to participants in the plan (EBSA, 2011: 66,136). Exemptions from these prohibitions do exist and permit actions by any party so long as the actions fit within the terms of the exemption. EBSA has provided guidance and exemptions over time regarding the provision of investment advice on benefit plan assets. As explained later, legislation in 2006 provided a new, statutory prohibited transaction exemption for certain transactions connected with the provision of investment advice (Muir, 2010).

The Advisers Act also contains categorical prohibitions relating to investment advice. For example, it prohibits investment advisers, whether registered with the SEC or not, from charging advisory fees based on account performance. There are limited exceptions from that prohibition, such as for advice provided to high net worth individuals.

The third legal response to conflicts of interest is to designate the conflicted adviser as a fiduciary. Because of the complexity involved in fiduciary obligation and the incentives established by such a designation we address those matters next, and in some detail.

Investment advisers as fiduciaries

First we discuss the standard of conduct a fiduciary investment adviser must meet and compare it with the standards applied to non-fiduciary advisers. Next we describe the lines the current legal definitions draw between when an investment adviser is a fiduciary and when an adviser is not a fiduciary. Then we explain how the standards and the technical legal definitions result in confusion among investors about whether the investment advice they receive is provided by a fiduciary or a non-fiduciary adviser.

The effect of fiduciary regulation on investment advisers

The legal obligations owed by a fiduciary to its clients significantly exceed the obligations owed in traditional contracting relationships. The higher standard is the point of imposing a fiduciary obligation to mitigate conflicts of interest. The precise obligations of a fiduciary vary depending on factors such as context and statutory provisions. There is general agreement though that all fiduciaries must meet the basic duties of: (*a*) loyalty, which requires the fiduciary to act in the client's best interest, and (*b*) care, which requires the fiduciary to act reasonably on the client's behalf (Laby, 2008: 105–6). The duty of loyalty responds directly to the threats imposed by conflicts of interests and generally requires, among other things, that a fiduciary subordinate its own interests to the interests of its client (Laby, 2011: 1055).

ERISA implements the fiduciary duty of loyalty through its statutory 'exclusive purpose rule.' As a result, fiduciaries of employee benefit plans, including 401(k) plans, must act for the purpose of providing plan benefits and paying plan expenses and not for their own benefit. For example, if management fiduciaries advised employees with employer stock in their 401(k) plans not to tender company stock in a tender offer in order to entrench management, that advice probably would violate the exclusive purpose fiduciary obligation (Muir, 2002: 21).

Similarly, the Advisers Act requires an investment adviser to 'serve the best interests of its clients, which includes an obligation not to subordinate the clients' interests to its own' (SEC Staff, 2011*b*: 22). The Advisers Act also requires an investment adviser to disclose information on conflicts of interest (SEC Staff, 2011*b*: 22).

In contrast with the fiduciary duty of loyalty, non-fiduciaries are often referred to as interacting with others at 'arm's length.' At arm's length is the standard that typically is applied to business transactions where each party is expected to work or negotiate in its best interest. Black's law dictionary defines at arm's length as: 'Beyond the reach of personal influence or control . . . [w]ithout trusting to the other's fairness or integrity' (Black, 1983). Specifically, broker-dealers who are not fiduciaries because they provide financial advice that is incidental to their work as broker-dealers and do not receive 'special compensation' for the investment advice are governed by a suitability standard—the advice must be suitable for the client. Suitability is a lower standard than a requirement to act in a client's best interest. The standard of care required of insurance agents depends on the law of the relevant state but may be a suitability standard (GAO, 2011*b*: 16–17).

Understanding the effect of fiduciary regulation on investment advisers requires understanding not just the obligations imposed on advisers but also the penalties imposed for fiduciary breach. ERISA permits EBSA or individuals to bring lawsuits for breach of fiduciary duties and contains potentially severe penalties. Those harmed by a fiduciary breach may receive a monetary award to compensate for the harm. And, a court may prohibit a breaching person or entity from acting as a fiduciary to other ERISA plans (Stanley, 2000: 701). Some commentators have argued that these relief provisions are insufficient to discourage illegal conduct because punitive damages, pain and suffering, and similar kinds of relief are not available (Schultz, 2011). By contrast, the Advisers Act does not permit individual investors to bring lawsuits alleging fiduciary breach; instead the SEC has enforcement authority (SEC 44). That authority permits the SEC to impose a variety of remedies for fiduciary breach, including monetary penalties and revocation of the adviser's registration (SEC Staff, 2011*b*: 44, A-17).

The law imposes fiduciary standards and penalties for breach of those standards in order to protect investors from conflicts. Entities that provide investment advice may react to the fiduciary standards in one of three ways. First, the investment adviser might comply with the fiduciary standards. This may result in higher costs for advice as a result of compliance efforts (e.g., SEC Staff, 2011*b*: 146). As is typical with regulation, the increased costs that result from compliance may be passed along to the investors who receive advice and to benefit plans that hire advice providers. The increased costs may result in decreased use of investment advice. Second, if the fiduciary standards are imposed by ERISA then the investment adviser might refuse to provide advice regarding benefit plan assets. Again, the result is that the imposition of the fiduciary standard would result in a decrease in the amount of advice available to benefit plans and to the individuals who earn benefits under the plans. The third possibility is that an adviser may avoid the cost of fiduciary regulation by providing investment advice in such a way that the adviser avoids being categorized by the law as a fiduciary. Next we discuss the line drawing that determines fiduciary status and the steps an adviser might take to avoid that status.

Current legal definition of investment advisers as fiduciaries

As we noted earlier, various terms are used in the brokerage and advisory industries to describe individuals and entities that provide advice on financial matters. Most of those terms do not have a precise legal definition. However, since fiduciary status gives rise to significant duties, substantial penalties for breach of those standards, and, thus, possibly an incentive to avoid fiduciary status, the definition of when an investment adviser is a fiduciary is important to both advisers and their clients. The regulators continue to struggle with the definitional questions. Here the complexity resulting from overlapping regulation becomes apparent because each regulator has a different definition for when an investment adviser is a fiduciary.

As a general matter, the Advisers Act defines the term 'investment adviser' in a reasonably straightforward manner as an individual or entity who is compensated for providing advice related to investments in securities. The Advisers Act's requirements, including its fiduciary standards, apply to any entity that fits within the definition. There are, however, a number of exceptions from the definition of 'investment adviser,' including broker-dealers who provide investment advice that is incidental to their work as a broker-dealer and who do not receive 'special compensation' for the advice. The result of the exceptions, especially when combined with the various terminologies used in the industry, can be confusing for investors who then find it difficult to determine whether their adviser is obligated to work in their best interest or owes them only a duty to recommend a suitable investment.

Under ERISA the standards are different. The statute contains alternate ways a person interacting with a benefit plan or its assets might become a fiduciary. The relevant language for investment advisers is that a person is a fiduciary if 'he renders investment advice for a fee or other compensation, direct or indirect . . . ' (ERISA, 1974: Sec. 3(21)). This relatively clear language, however, is complicated by regulations. The regulations have long made clear that provision of investment education is not in itself a fiduciary action (Muir, 2002: 18–19). Thus, a rational provider of investment-related services may choose to provide only investment education or to charge higher fees for investment advice than for investment education. This gives rise to legal issues over the line between investment advice and investment education (Muir, 2002).

A second set of complications results from regulations issued in 1975 that established a significantly narrower, five-part definition of when a provider of investment advice becomes a fiduciary regarding benefit plan assets. In summary, according to the regulations, an investment adviser is not a fiduciary when giving advice regarding benefit plan assets or an IRA unless the adviser (*a*) advises on securities valuation or makes recommendations on the purchase or sale of securities, (*b*) on a regular basis, (*c*) according to a mutual agreement with the plan or a plan fiduciary, (*d*) that provides the advice will serve as the primary basis for decisions on investments, and (*e*) the advice is individualized to the plan's needs (EBSA, 2010). By avoiding meeting this narrower regulatory definition when giving advice, a financial adviser currently may give investment advice for a fee regarding benefit plan assets but avoid the fiduciary obligations imposed on an adviser who provides advice regarding the assets of a benefit plan or IRA.

Investor confusion resulting from industry practice

The complexities in the current definitions of when an adviser is a fiduciary combined with the lack of uniform terminology, the variety of services an adviser may provide, and the many different professional designations have given rise to concerns that investors can be confused about the standard of care owed to them by their adviser. A study by the GAO, an independent, investigative agency that reports to Congress, of financial planners observed that when one individual or firm provides a variety of services, the standard of care may vary with the services. This finding was consistent with an earlier study by the RAND Corporation of various perspectives on investment adviser and broker-dealer services (Hung et al., 2008). The variation of the standard of care with the type of service provided is known as a 'hat-switching' problem. For example, if the financial planner is purchasing securities for the client, the planner is wearing its broker-dealer hat and owes only a duty of suitability. When the planner provides advice under the classic Advisers Act definition of investment advice, the planner is wearing its Advisers Act hat and must act in the client's best interest (GAO, 2011*b*). An additional point of confusion not discussed by the GAO is that if the planner is providing advice regarding benefit plan assets and meets ERISA's definition of a fiduciary then the planner is wearing its ERISA fiduciary hat. This results in application of a standard of care similar to the Advisers Act fiduciary standard but, as explained above, a different set of remedies if the standard of care is breached.

The GAO's observations about the possibility of investor confusion are backed up by other research. Focus group studies indicate that investors do not understand the differences between investment advisers and broker-dealers, including the different types of services the two groups provide and the differences in their legal obligations (SEC Staff, 2011*b*). A larger study identified the interlocking relationships between entities that offer a variety of services, such as both brokerage and advisory services, as one source of the difficulty investors have in teasing apart the obligations. The GAO has recommended that a study the SEC is currently doing on the financial literacy of investors includes an investigation into whether investors are confused by the various certifications used and roles played by financial advisers and, if so, whether the confusion affects investment decisions (GAO, 2011*b*).

Current rule making and reports on fiduciary investment advisers

As noted above, the regulation of investment advisers has long been part of the agendas of the SEC and EBSA. In recent years, the agencies have undertaken studies and proposed regulations regarding investment advice, some of which have come at the direction of Congress. In 2006, the Pension Protection Act (PPA) initiated EBSA regulatory efforts to expand access to investment advice. The SEC and EBSA have issued reports and regulations related to investment advice in the wake of the financial crisis and as directed by Congress in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank, 2010). To explore these, we begin by discussing the agencies' actions on the definitional question of what types of actions are subject to fiduciary duties. Next we review recent regulations that expand the ways in which advisers may offer investment advice to 401(k)-type plan participants and holders of IRAs. In a final section, we explain efforts to expand the disclosure of fees charged in 401(k) plans.

In early 2011, as required by the Dodd-Frank Act, the Staff of the SEC issued a report evaluating the regulation of investment advice provided by both investment advisers and broker-dealers. As noted above, the Advisers Act contains a broad definition of 'investment adviser' but excludes broker-dealers from its regulation if the broker-dealer's provision of advice is incidental and it does not receive any 'special compensation' for the advice. The SEC Staff's study of this bifurcated regulatory system concluded that a unified federal fiduciary standard and regulatory system should be applied to both investment advisers and to broker-dealers when they provide individualized investment advice to retail customers (SEC Staff, 2011*b*). If adopted, the unified standard would decrease the incidence of the hat-switching problem. The report was controversial even at the highest levels of the SEC. Three of the SEC Commissioners, those who govern the SEC, voted to submit the Staff study to Congress, over the objection of two Commissioners. The Dodd-Frank Act granted the SEC authority to apply the same standards to broker-dealers as apply to investment advisers under the Advisers Act. There were indications that the SEC would propose regulations on the topic in early 2012 (Christie, 2011) but that effort has been delayed indefinitely while the SEC gathers cost–benefit data (Zamansky, 2012). The SEC and Congress also are considering changes to the way compliance examinations of investment advisers are conducted, including the possibility of a self-regulatory organization with authority for additional oversight (SEC Staff, 2011*a*).

On the fiduciary definitional question, in 2010 EBSA proposed a change in its long-standing regulation defining when the provision of investment advice regarding benefit plan or IRA assets results in fiduciary status. The result would be that an investment adviser would no longer have to provide individualized advice on a regular basis according to an agreement that the advice would be the primary basis for the investment decision in order to be considered a fiduciary of a benefit plan or IRA. The proposal would have dramatically increased the scope of financial advisory activities that result in a provider becoming a fiduciary when giving investment advice regarding benefit plan or IRA assets. The proposed regulatory definition tracked the general statutory definition and specifically stated that investment advice or recommendations given to a plan participant or beneficiary or to an investor regarding an IRA are a fiduciary act (EBSA, 2010). By decreasing the ability of individuals and entities to avoid fiduciary status, the proposed standard would have decreased the incidence of the hat-switching problem. In September 2011, EBSA withdrew the proposed regulations, which had generated substantial controversy (DOL, 2011). Current indications are that it will revise and re-propose the regulations in 2013 while continuing to coordinate its efforts with the SEC.

As discussed above, both ERISA's fiduciary and prohibited transactions rules impose constraints on the provision of investment advice regarding benefit plan assets. To date, investment advice provided by ERISA fiduciaries, a role held by many large financial institutions, to holders of 401(k) accounts typically has been structured to meet one of two models approved by EBSA in opinion letters. The first is known as the SunAmerica model. It allows financial entities to provide advice though computer models if the computer models are developed and controlled by an independent third party. The second model is the level fee model. It prohibits the investment adviser's compensation, or the compensation of any employer or affiliate of the adviser, from varying as a result of the investment choices made according to the advice (Muir, 2009).

In 2006, Congress enacted the PPA, which explicitly addressed the regulation of investment advice provided in benefit plans, and theoretically granted more flexibility to investment advice providers than existed under the SunAmerica or level fee models. However, Congress left a number of details in the PPA to be determined by EBSA through the regulatory process. The agency's initial regulations interpreting the PPA provisions were extremely controversial, because they arguably provided more flexibility than the legislation mandated, and were not implemented (Muir, 2009). After making significant revisions, EBSA finalized those regulations and they became effective in December 2011.

The new regulations do not change the old fee leveling and computer model platforms but do give advice providers alternative ways to structure their advice products. In order to utilize either of the new exemptions, an investment advice provider must meet a number of technical requirements. One of the requirements of the new regulations is that advisers must request details from each investor regarding such factors as age, risk tolerance, current investments, and other assets. Another is that any computer model must take into account nearly all of the investment options available in a plan including company stock. The requirements of fee leveling do not extend to the affiliates of the adviser. Thus, if the adviser is affiliated with an entity that provides investment products, the fees of the affiliate that result from the investment advice are permitted to vary depending on the investments made as a result of that advice.

As discussed above, disclosure is one of the general mechanisms the law uses to mitigate conflicts of interest. EBSA has taken action in the last few years to enhance the disclosure of investment-related fees by issuing two new regulations on fees. The first is effective for contracts as of July 2012, requiring service providers who are fiduciaries or registered investment advisers providing a broad array of services and expecting to receive at least $1,000 in compensation to disclose that compensation to plan fiduciaries. For certain services believed to be significant or to present possible conflicts of interest, the services and costs must be described separately even if the services and costs are bundled. The second regulation is linked to the effective date of the fiduciary disclosure regulation and was generally applicable in August 2012. It requires plans to provide participants and beneficiaries in DC (e.g., 401(k)) plans with information about the plan and with investment-related information including performance data and fee and expense information related to investment alternatives (EBSA, 2010).

Conclusion

Because of the dominance of 401(k) plans and IRAs in the US retirement planning landscape, the market for financial advice is of increasing importance to pension policy. Researchers have documented numerous factors, from lack of financial sophistication to lack of interest, that inhibit individuals from making optimal investment decisions. In contrast to the challenges faced by individuals who make their own investment decisions, the US Department of Labor estimated that in 2010 financial advice saved pension participants $15 billion in financial errors (EBSA, 2011). Policymakers and plan sponsors have recognized the potential benefits investment advisers can provide and, thus, have sought to enhance the quantity and quality of financial advice available to individuals with IRA and 401(k) accounts.

Our examination of the market for financial advice establishes several of the market's characteristics provide important flexibility and information to advisory clients. Advisers engage with clients in a variety of ways, from providing individualized advice to managing assets, which permits services to be tailored to individual needs. The scope of advice provided may be shaped to accommodate the level of complexity of a client's financial situation. Similarly, an individual interested in engaging an investment adviser has access to a significant volume of information about the adviser as a result of federal disclosure requirements and numerous potential professional certifications, in addition to the extensive marketing done by some advisers. Finally, fee structures for investment advice vary in numerous ways.

The flexibility and variability in the market for financial advice, however, also result in complexity that poses two related hazards. First, the presence of conflicts of interest, which are inherent in some fee structures, may result in some advisers providing investment advice that is not always in the best interest of their clients. The conflicts may not always be obvious to the individuals and benefit plans that seek investment advice. Second, because of the variety of certifications, different types of financial market participants who provide advice, and layers of disclosure and marketing materials, advisory clients may be unaware or confused about the level of legal protections that govern their relationships with their advisers. This is especially true when an adviser provides a client with various services that are governed by different standards of care, giving rise to the 'hat-switching' problem. The client may not understand that the adviser must act in the client's best interest in some transactions but in others merely must provide advice suitable to the client's situation.

The regulatory framework addresses both conflicts of interest and investors' informational requirements. The three mechanisms utilized by the regulatory system—disclosure requirements, prohibitions on some actions, and the imposition of fiduciary duty—are useful regulatory tools that provide significant protection to participants and establish a floor for industry standards. However, here too complexity has costs. For example, the overlapping regulatory jurisdiction has resulted in a variety of different disclosure requirements depending on the type of service being provided. And, whether an advice provider is a fiduciary or not may depend on whether the advice involves assets of a tax-favored retirement account. These and other complexities sometimes result in confused investors and a subset of advice providers who choose to operate in ways that may be less than optimal for their clients or the advice industry. Regulatory efforts are underway in the United States to address informational issues and to rationalize the application of fiduciary standards, with the ultimate goal being to increase the quality and quantity of investment advice to support retirement security.

We have received excellent research assistance from Alexandra Kahn and Jonathan Roselle, have benefited from discussions with Stephen Utkus and Ron Gebhardtsbauer on some issues discussed in this chapter, and have received valuable comments from Arthur Laby, Olivia S. Mitchell, and Kent Smetters.

Endnotes

1. Due to space limitations, we do not consider a number of related topics including financial advice to individuals as small business owners, such as advice on what type of pension plan to offer, or advice to individuals concerning tax planning, estate planning, insurance, or obtaining a mortgage. We also exclude advice to people with high net worth, because they are relatively few and presumably are more sophisticated investors than people with lower net worth. Having high net worth does not guarantee that people are satisfied with the financial advice they receive; one survey of affluent investors found that 85 percent was sufficiently dissatisfied as to consider switching advisers (Girouard, 2010). The Securities and Exchange Commission (SEC, 2011*a*) defines for purposes of its ADV Form an individual with high net worth as an individual with at least $750,000 managed by one company, or whose net worth a company reasonably believes exceeds $1,500,000. The net worth of an individual may include assets held jointly with his or her spouse.
2. One financial columnist recommends financial advisers with the Certified Financial Planner designation (Anspach, 2011*b*) and advisers with the Personal Financial Specialist (PFS) designation, a designation that only Certified Public Accountants (CPAs) can earn. For investment advisers, she recommends Chartered Financial Analysts (CFAs).

References

American Institute of Certified Public Accountants (2011). *Personal Financial Planning*. New York, NY: American Institute of CPAs. http://www.aicpa.org/InterestAreas/Personal%20FinancialPlanning/Pages/default.aspx

Ameriprise (2011). *Purchasing Mutual Funds and 529 Plans through Ameriprise Financial*. Minneapolis, MN: Ameriprise Financial, Inc. http://investment.ameriprise.com/mutual-funds/purchasing-mutual-funds-thru-ameriprise.asp

Anspach, D. (2011*a*). *6 Ways Financial Advisors Charge Fees*. New York, NY: About.com. http://moneyover55.about.com/od/findingqualifiedadvisors/a/finadvisorfees.htm

—— (2011*b*). *Understanding Financial Advisor Credentials*. New York, NY: About.com. http://moneyover55.about.com/od/findingqualifiedadvisors/a/advisorcred.htm

Bank of America Merrill Lynch (2011). *Retirement & Benefit Plan Services*. New York, NY: Bank of America Corporation. http://www.benefitplans.baml.com/IR/Pages/ts_er.aspx

Benartzi, S., and R. H. Thaler (2002). 'How Much is Investor Autonomy Worth?' *Journal of Finance*, 57(4): 1593–616.

Benjamin F. Edwards & Co. (2011). *Mutual Fund Sales Charges and Breakpoints*. St. Louis, MO: Benjamin F. Edwards & Co. www.benjaminfedwards.com/content.php?pageID=mut_fund_discl

Black, H. C. (1983). *Black's Law Dictionary*. St. Paul, MN: West Publishing Co.

Bliman, N. (2011). 'BrightScope Roles Out Adviser Data Base,' *PlanAdviser*. Stamford, CT: Asset International, Inc. http://www.planadviser.com/NewsArticleProducts.aspx?id=14286&page=1

BrightScope, Inc. (2011). *Advisor Pages*. San Diego, CA: BrightScope, Inc. http://www.brightscope.com/financial-planning/find/advisor/

Bucks, B. F., A. B. Kennickel, T. L. Mach, and K. B. Moore (2009). 'Changes in US Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances,' *Federal Reserve Bulletin*, February: A1–A56. http://www.federalreserve.gov/pubs/bulletin/2009/pdf/scf09.pdf

Certified Financial Planner Board (2011*a*). *CFP Board Mission*. Washington, DC: Certified Financial Planner Board of Standards, Inc. http://www.cfp.net/

—— (2011*b*). *Topic List for CFP Certification Examination*. Washington, DC: Certified Financial Planner Board of Standards, Inc. http://www.cfp.net/downloads/Financial%20Planning%20Topics%202006.pdf

—— (2011*c*). *Types of Financial Advisors*. Washington, DC: Certified Financial Planner Board of Standards, Inc. http://letsmakeaplan.org/Why-You-Need-A-Plan/Types-of-Financial-Advisors.aspx?gclid=CNrpgrKLuKoCFeJ65Qodv%20DYT8A

Chartered Financial Analyst (CFA) Institute (2011). *What We Stand For*. New York, NY: CFA Institute. http://www.cfainstitute.org/about/strategy/Pages/index.aspx

Choi, J. J., D. Laibson, and B. Madrian (2004). 'Plan Design and 401(k) Savings Outcomes,' *National Tax Journal*, 52(2): 275–98.

Christie, S. (2011). 'IAA's Tittsworth: Fiduciary Ruling Likely in Q1 of 2012: RIS,' *AdvisorOne*. Erlanger, KY: AdvisorOne. http://www.advisorone.com/2011/10/21/iaas-tittsworth-fiduciary-ruling-likely-in-q1-of-2

Dodd-Frank Wall Street Reform and Consumer Protection Act (2010). Public Law 111–203.

Drucker, D. J. (2005). 'Accounting for CPA Referrals: Why Are CPAs Selling Client Referrals, and Should You Be Buying?' *Financial Advisor*. Shrewsbury, NJ: Charter Financial Publishing Network, Inc. http://www.fa-mag.com/component/content/article/1126.html?issue=56&magazineID=1&Itemid=27

Edelman Financial Services (2011). *The Edelman 401(k)—Ric Edelman*. Fairfax, VA: Edelman Financial Services. http://www.ricedelman.com/galleries/default-file/401k_brochure_0617.pdf

Employee Retirement Income Security Act (1974). Public Law 93–406.

Financial Engines (2011). *Understanding the Accidental Investor: Baby Boomers on Retirement*. Palo Alto, CA: Financial Engines, Inc. http://corp.financialengines.com/employer/Accidental_Investor_April2011.pdf

FINRA (2011*a*). *Understanding Professional Designations*. Washington, DC: Financial Industry Regulatory Authority, Inc. http://apps.finra.org/DataDirectory/1/prodesignations.aspx

—— (2011*b*). 'Use FINRA BrokerCheck to Review Your Broker's Record.' *Investor Newsletter*. Washington, DC: FINRA. July. http://www.finra.org/Investors/Subscriptions/InvestorNews/P123886

Girouard, J. E. (2010). 'Why Clients Distrust Advisors,' *Forbes*. New York, NY: Forbes.com. http://www.forbes.com/2010/04/06/client-retention-financial-advisor-network-high-net-worth.html

GuidedChoice (2011). *Pricing and Fees*. San Diego, CA: GuidedChoice, Inc. http://www.guidedchoice.com/index.php?option=com_content&view=article&id=33&Itemid=15

Hastings, J. S., and O. S. Mitchell (2011). 'How Financial Literacy and Impatience Shape Retirement Wealth and Investment Behaviors,' National Bureau of Economic Research Paper No. 16740. Cambridge, MA: NBER.

Hung, A. K., N. Clancy, J. Dominitz, E. Talley, C. Berrebi, and F. Suvankulov (2008). 'Investor and Industry Perspectives on Investment Advisers and Broker-Dealers,' RAND Technical Report. Santa Monica, CA: RAND. http://www.rand.org/pubs/technical_reports/TR556.html

Infogroup/ORC (2010). *Elder Investment Fraud and Financial Exploitation: A Survey Conducted for Investor Protection Trust*. Papillion, NE: Infogroup/ORC. http://www.investorprotection.org/downloads/EIFFE_Survey_Report.pdf

Investment Adviser Association (2011). *Chartered Investment Counselor Program and Designation*. Washington, DC: Investment Adviser Association. https://www.investmentadviser.org/eweb/dynamicpage.aspx?webcode=cic

Investment Company Institute (2011*a*). 'The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2010.' *ICI Research Perspective*, 17(4). Washington, DC: Investment Company Institute.

—— (2011*b*). *The US Retirement Market: Third Quarter 2010*. Washington, DC: Investment Company Institute. http://www.ici.org/pdf/ppr_11_retire_q3_10.pdf

Karp, N., and R. Wilson (2011). 'Protecting Older Investors: The Challenge of Diminished Capacity,' AARP Public Policy Institute Research Report No. 2011–04. New York, NY: AARP Public Policy Institute.

Kolakowski, M. (2011). *Insurance Sales Agents*. New York, NY: About.com. http://financecareers.about.com/od/insurance/a/insuranceagent.htm

Laby, A. B. (2008). 'The Fiduciary Obligation as the Adoption of Ends,' *Buffalo Law Review*, 56(1): 100–67.

—— (2011). '*SEC v. Capital Gains Research Bureau* and the Investment Advisers Act of 1940,' *Boston University Law Review*, 91(3): 1051–104.

Loewenstein, G., M. C. Daylian, M. Cain, and S. Sah (2011). 'The Limits of Transparency: Pitfalls and Potential of Disclosing Conflicts of Interest,' *American Economic Review*, 101(3): 423–28.

Lusardi, A., and O. S. Mitchell (2006). 'Financial Literacy and Planning: Implications for Retirement Wellbeing,' Pension Research Council Working Paper No. WP 2006-1. Philadelphia, PA: Pension Research Council.

Maxey, D. (2011). 'How to Pay Your Financial Adviser.' *The Wall Street Journal*. December 12.

McCarthy, D. M., and J. A. Turner (2000). 'Pension Education: Does It Help? Does It Matter?' *Benefits Quarterly*, 16: 64–72.

Merrill Edge (2011). *Invest with Advisors*. New York, NY: Bank of America Corporation. http://www.merrilledge.com/m/pages/merrill-edge-advisory-center.aspx

Merrill Lynch (2010). *Global Wealth & Investment Management*. New York, NY: Bank of America Corporation. http://www.ml.com/?id=7695_8134_114044

MetLife (2011). *About MetLife Securities, Inc.* New York, NY: Metropolitan Life Insurance Company. http://www.metlife.com/individual/investment-products/mutual-fund/index.html?WT.ac=GN_individual_investment-products_mutual-fund

Moon, Kenneth P. (2004). *Mutual Fund Revenue Sharing and the Role of the Fiduciary*. Washington, DC: Financial Planning Association. http://www.fpanet.

org/journal/BetweentheIssues/LastMonth/Articles/MutualFundRevenueSharin gandtheRoleoftheFiduciary/

Muir, D. M. (2002). 'The Dichotomy Between Investment Advice and Investment Education: Is No Advice Really the Best Advice?' *Berkeley Journal of Employment and Labor Law*, 23(1): 1–55.

—— (2009). 'Legislation Pending on Investment Advice to 401(k) Account Clients,' *Bank Accounting & Finance*, 22(6): 38–40.

——ed. (2010). *Employee Benefits Law 2010 Cumulative Supplement*. Arlington, VA: BNA Books.

New Means Financial Planning (2011). *Services*. Nashua, NH: New Means Financial Planning. http://www.newmeans.com/services.html

Pettus, L., and R. H. Kesmodel, Jr. (2010). 'Impact of the Pension Protection Act on Financial Advice: What Works and What Remains to be Done?' in R. L. Clark and O. S. Mitchell, eds., *Reorienting Retirement Risk Management*. Oxford, UK: Oxford University Press, pp. 86–104.

Reish, F., and B. Ashton (2011). 'Fiduciary Issues Related to the Allocation of Revenue Sharing,' White Paper. Washington, DC: Drinker Biddle. http://www.securiannews.com/sites/securian.newshq.businesswire.com/files/white_paper/file/ReishPaperFinal.pdf

Schultz, E. E. (2011). *Retirement Heist*. New York, NY: Penguin Group.

Schwab (2011*a*). *Advice Guidelines*. San Francisco, CA: The Charles Schwab Corporation. http://www.schwab.com/public/schwab/nn/legal_compliance/compensation_advice_disclosures/advice_guidelines.html

—— (2011*b*). *How We Compensate our Investment Professionals*. San Francisco, CA: The Charles Schwab Corporation. http://www.schwab.com/public/schwab/nn/legal_compliance/compensation_advice_disclosures/investment_professionals_compensation.html

Simon, W. S. (2004). 'Fiduciary Focus: How to Bring Value to 401(k) Sponsors,' *Morningstar Advisor*. Chicago, IL: Morningstar, Inc. http://advisors.morningstar.com/advisor/t/54224664/fiduciary-focus-how-to-bring-value-to-401-k-sponsors.htm?&q=how+to+bring+value+to+401%28k%29+sponsors&single=true

Smart401(k) (2011). *Stop Guessing. Start Planning. Take Control of Your Retirement and Invest with Confidence*. Overland Park, KS: Smart401(k). http://www.smart401k.com/Content/Retail/Retail-Landing-Pages/simplify-401k-investing.aspx

Staff of the United States Securities and Exchange Commission (SEC Staff) (2011*a*). *Study on Enhancing Investment Adviser Examinations*. Washington, DC: SEC. http://www.sec.gov/news/studies/2011/914studyfinal.pdf

—— (2011*b*). *Study on Investment Advisers and Broker-Dealers*. Washington, DC: SEC. http://www.sec.gov/news/studies/2011/913studyfinal.pdf

Stanley, J. K., ed. (2000). *Employee Benefits Law*. Arlington, VA: BNA Books.

TD Ameritrade (2011). *Amerivest Guided Portfolios*. Omaha, NE: Ameritrade. http://www.tdameritrade.com/offer/ad/investmentservices.html

The American College (2011*a*). *Chartered Financial Consultant*. Bryn Mawr, PA: The American College. http://www.theamericancollege.edu/financial-planning/chfc-advanced-financial-planning

—— (2011*b*). *Chartered Life Underwriter*. Bryn Mawr, PA: The American College. http://www.theamericancollege.edu/insurance-education/clu-insurance-specialty

The Motley Fool (2011). *Whom to Hire*. Alexandria, VA: The Motley Fool. http://www.fool.com/financial-advice/whom-to-hire.aspx?source=famp

T. Rowe Price (2011*a*). *Advisory Planning Services*. Baltimore, MD: T. Rowe Price. http://individual.troweprice.com/public/Retail/Products-&-Services/Advisory-Planning-Services/FAQs

—— (2011*b*). *Benefits of Advisory Planning Services*. Baltimore, MD: T. Rowe Price. http://individual.troweprice.com/public/Retail/Products-&-Services/Advisory-Planning-Services/Benefits

Turner, J. A. (2010). 'Why Don't People Annuitize? The Role of Advice Provided by Retirement Planning Software,' Pension Research Council Working Paper No. WP2010-07. Philadelphia, PA: Pension Research Council. http://www.pensionresearchcouncil.org/publications/document.php?file=858

——H. A. Witte (2008). *Fee Disclosure to Pension Participants: Establishing Minimum Standards*. Toronto, Canada: Rotman International Centre for Pension Management. http://www.rotman.utoronto.ca/userfiles/departments/icpm/File/John%20Turner_%20Pension%20Fee%20Disclosure_August%202008_FINAL_for%20webposting.pdf

—— (2009). 'Retirement Planning Software and Post-retirement Risks,' *Society of Actuaries and Actuarial Foundation*. Schaumburg, IL: Society of Actuaries. http://www.soa.org/research/research-projects/pension/retire-planning-software-post-retire-risk.aspx

US Department of Labor (DOL) (2011). *US Labor Department's EBSA to Repropose Rule on Definition of a Fiduciary*. 11-1382-NAT. Washington, DC: DOL.

US Department of Labor, Employee Benefits Security Administration (EBSA) (2010). *Proposed Regulation, Definition of the Term 'Fiduciary.'* 75 Fed. Reg. 65, 263–5, 278. Washington, DC: EBSA.

—— (2011). *Requirements for Fee Disclosure to Plan Fiduciaries and Participants—Applicability Dates*. 76 Fed. Reg. 42,539–42,542. Washington, DC: EBSA.

US Government Accountability Office (GAO) (2011*a*). *401(k) Plans: Improved Regulation Could Protect Participants from Conflicts of Interest*. GAO-11-119. Washington, DC: GPO.

—— (2011*b*). *Regulatory Coverage Generally Exists for Financial Planners, But Consumer Protection Issues Remain*. GAO-11-235. Washington, DC: GPO.

US Securities and Exchange Commission (SEC) (2011*a*). 'Fees Make a Big Difference.' Washington, DC: SEC. http://www.sec.gov/investor/tools/mfcc/fee-comparison-help.htm

—— (2011*b*). *Frequently Asked Questions on Form ADV and IARD*. Washington, DC: SEC. http://www.sec.gov/divisions/investment/iard/iardfaq.shtml#networth

—— (2011*c*). *General Information on the Regulation of Investment Advisers*. Washington, DC: SEC. http://www.sec.gov/divisions/investment/iaregulation/memoia.htm

—— (2011*d*). *Protect Your Money: Check Out Brokers and Investment Advisers*. Washington, DC: SEC. http://www.sec.gov/investor/brokers.htm

—— (2011*e*). *Rules Implementing Amendments to the Investment Advisers Act of 1940*. 76 Fed. Reg. 42,950. Washington, DC: SEC.

—— (2011*f*). *Variable Annuities: What You Should Know*. Washington, DC: SEC. http://www.sec.gov/investor/pubs/varannty.htm

Vanguard (2011*a*). *The Ongoing Advice You Want from a Partner You Can Trust.* Malvern. PA: The Vanguard Group. https://personal.vanguard.com/us/LiteratureRequest?FW_Activity=ViewOnlineActivity&litID=2210056021&FW_Event=start&view_mode=web&usage_cat2=&viewLitID=2210056021&formName=Asset+Management+Services+for+Individuals&vendorID=S177&cbdForceDomain=true

—— (2011*b*). *Guidance and Advice.* Malvern, PA: The Vanguard Group. https://personal.vanguard.com/us/whatweoffer/advice

Veritat (2011). *Finally, Financial Planning for Everyone.* Philadelphia, PA: Veritat. https://www.veritat.com/

Zamansky, J. (2012). 'SEC Struggles with Investor-Protection Rules,' *Forbes.* New York, NY: Forbes.com. http://www.forbes.com/sites/jakezamansky/2012/01/24/sec-struggles-with-investor-protection-rules/