Chapter 7

Investor Knowledge and Experience with Investment Advisers and Broker-Dealers

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During the tenure of Chairman Arthur Levitt, the Securities and Exchange Commission (SEC) commissioned the 1995 Report of the Committee on Compensation Practices (the 'Tully Report') responding to a concern about conflicts of interest in the retail brokerage industry. This report (Tully and Levitt, 1995) identified 'best practices' as those that attempted to more closely align the interests of the investor, the registered representative, and the firm. Fee-based accounts, as opposed to commissioned transactions, were highlighted as a best practice because these reduce the likelihood of abusive sales practices such as churning, high-pressure sales tactics, and recommending unsuitable transactions. Fee-based accounts allow for registered representatives to be compensated based on the amount of assets in an account regardless of transaction activity.

The release of the Tully report coincided with an increase in competition in the US retail brokerage industry, as well as falling transaction-based commissions, the traditional source of income for registered representatives. As a result, more brokerage firms began to offer fee-based programs. As such fee-based accounts were similar to advisory programs offered by investment advisers, there was some concern that broker-dealers that offered such accounts would be providing advice that was more than 'solely incidental' to the transaction and trigger application of the Investment Advisers Act of 1940 (US Statutes, 1940).

The 1940 Act regulates activities of investment advisers, whereas the Securities Exchange Act of 1934 (US Statutes, 1934) regulates the activities of broker-dealers, who are also subject to oversight by self-regulating organizations (SROs). The 1940 Act defines 'investment adviser' as 'any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities' (US Statutes, 1940). In order to avoid duplicate regulation of broker-dealer activities, the 1940

Act makes an exception for 'any broker or dealer whose performance of [advisory] services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor' (US Statutes, 1940).

The SEC studied these new fee-based brokerage programs and concluded that they were traditional brokerage offerings that had been re-priced, rather than new advisory programs. Therefore, in 1999 the SEC proposed a rule (202(a)(11)-1) that, among other things, exempted broker-dealers offering fee-based brokerage accounts from being subject to the Advisers Act. The SEC thought that if the 1940 Act applied to broker-dealers providing such fee-based programs, it would discourage the offering of such programs and that these fee-based programs would be beneficial to brokerage customers (SEC, 2005).

Many commentators on the 1999 proposed rule felt that such an exclusion would blur the lines between broker-dealers and investment advisers, and it might also confuse investors about their rights and the obligations owed to them under each type of financial relationship. In response to these and other comments, the SEC modified and reproposed the rule in 2005. The reproposed rule, 'Certain Broker-Dealers Deemed Not To Be Investment Advisers', expanded the disclosure requirements of broker-dealers offering investment advice by ensuring that any advertisements or literature identifies the account as a brokerage account (SEC, 2005).

Although the 2005 rule has since been vacated, the rulemaking process did raise concerns by the SEC as to what investors understand regarding brokerage and advisory accounts, the legal obligations of each type of account, and the effect of titles and marketing used by investment professionals on investors' expectations. As a result, the SEC commissioned the RAND Corporation to study the issue of what investors understand about the differences between investment advisers and broker-dealers. As part of that study, RAND conducted a household survey and a series of focus groups, to be described later. The policy question of how to address or harmonize the regulatory differences has recently been resurrected as part of financial regulatory reform legislation following the 2008 financial market collapse.[2]

This chapter asks what investors understand about a range of issues, including whether investors understand distinctions between broker-dealers and investment advisers. We also seek to learn about their experiences interacting with the financial service industry and their expectations of service provided by individual professionals and firms in the financial service industry. To address these points, we administered a large-scale national household survey, and also conducted six intensive focus-group discussions. The focus groups complement the national survey by providing a deeper understanding of how investors interact with the financial service industry and what they do and do not understand about the nature of that relationship. Participants in both the survey and the focus groups represent a range of ages, income levels, and racial and ethnic groups.

Our results show that most people lack a clear understanding of the boundaries between investment advisers and broker-dealers. Even those who have employed financial professionals for years are often confused about job titles, types of firms with which they are associated, and payments made for their services. Participants also understand relatively little about the legal distinctions between investment advisers and broker-dealers. Despite this confusion, people report that they are largely satisfied with the services they receive from financial professionals.

In what follows, we first review literature on investor perceptions and expectations of financial service providers. We then discuss results from our own research, results from a household survey, and focus-group discussions. The household survey addresses several major topics, including beliefs about the differences between investment advisers and broker-dealers and experience with different types of financial service providers. The focus-group results amplify the results from the household survey.

Prior literature: investor perceptions and expectations of financial service providers

A handful of studies examine investors' understanding of the differences between financial service providers, and particularly between investment advisers and broker-dealers.

The Zero Alpha Group (ZAG, 2004) and the Consumer Federation of America commissioned a survey of 1,044 investors regarding regulation of brokers and investment advisers, who were asked, 'Based on your knowledge of stockbrokers, such as Merrill Lynch, Morgan Stanley, and Edward D. Jones, which ONE of the following statements do you believe BEST describes the services they provide to their customers?' About the same fraction (28 percent) of respondents believed that brokers' primary service was to provide financial advice, as those who believed that brokers' primary service was to conduct stock market transactions (26 percent). When asked the following question, 86 percent of respondents answered 'Yes': 'Stockbrokers receive financial incentives from investment product sponsors to recommend particular investments to their customers. If, for example, a stockbroker receives cash payments, vacation trips or other forms of compensation from a mutual fund company as an inducement to sell a particular mutual fund to his or her clients, should the stockbroker be required to disclose that fact to a customer buying the mutual fund?'

Almost all of the respondents (91 percent) reported that they thought that, if stockbrokers and financial planners offered the same type of investment advice services, the same investor protection rules should apply. Further, 65 percent of respondents reported that they would be much or somewhat less likely to use a stockbroker for investment advice, if brokers were subject to weaker investor protection rules than financial planners (Opinion Research Corporation, 2004).

In 2005, the SEC commissioned a study by Siegel and Gale, LLC and Gelb Consulting Group (2005). Four focus groups of investors in Tennessee and Maryland proved not to know the difference between brokers, financial advisors/financial consultants, investment advisers, and financial planners.

TD Ameritrade (2006) surveyed 1,000 investors and found that, even with the new 2005 disclosure rules, investors were still unclear about the distinction between brokers and investment advisers. When asked, 'Are you aware that stockbrokers and investment advisors offer fee-based financial advice but provide different levels of investor protection?', 43 percent of respondents reported they were unaware, and 47 percent of respondents reported that they did not know that brokers need not disclose all conflicts of interest. Over 60 percent of respondents believed that brokers had a fiduciary duty, and 90 percent of respondents believed that investment advisers had a fiduciary duty. Further, most respondents said they would not seek services from a broker if they knew that brokerage services provided fewer investor protections, that brokers lacked a fiduciary duty, or that brokers were not required to disclose all conflicts of interest. When shown the 2005 disclosure statement, 79 percent of respondents reported they would be less likely to seek financial advice from a brokerage firm. Moreover, 64 percent reported that they did not expect an unbiased response if they were to ask a broker about the differences between brokerage and advisory accounts.

A few studies focus on dimensions of service that help determine investors' satisfaction with their brokers. Fusilier and Schaub (2003) examine brokerage clients' perceptions and points of satisfaction, drawing on two surveys of investors: one in 1998 (bull market) of 760 respondents, and another in 2002 (bear market) of 388 respondents. Survey questions asked about perceptions of broker practices and satisfaction. They found that satisfaction was influenced by investor perception of broker honesty, expertise, knowledge, and service. Furthermore, they found that investor perceptions and level of satisfaction did not change significantly from the bull to the bear market. In a content analysis of 740 customer reviews of online brokerage services, Yang and Fang (2004) identified several quality dimensions related to satisfaction: responsiveness (e.g., prompt service, order execution, and order confirmation), service reliability (e.g., accurate quotes, order fulfillment, and calculation of commissions), competence (e.g., research capacity), and security (e.g., privacy). Chao et al. (2002) surveyed 139 investors with assets ranging from $1,000 to $1,300,000 to investigate features that matter to online traders. The most highly ranked features were lower trading costs, trading security, customer service, and technical support. The dimensions that mattered the least were reputation of the firm, ease of use of the website, reliability of trades, and ease of account opening and access. Service dimensions such as execution speed, real-time quotes, and access to IPOs were ranked as only moderately important.

Perceptions of provider performance

We collected data from US households via an Internet survey of investment behavior and preferences, experience with financial service providers, and perceptions of the different types of financial service providers. The survey was administered to members of the American Life Panel (ALP), a probability sample of over 1,000 individuals age 18+, who either used their own computers or a WebTV provided by RAND to participate in the panel. About once a month, respondents received an email with a request to visit the website and fill out questionnaires. Typically, an interview took less than 30 minutes. Respondents were paid an incentive of about $20 per 30 minutes of interviewing (and proportionately less if an interview was shorter).

The household survey was administered for six weeks, from September 26 through November 6, 2007, and, because it was conducted online, we had quick access to the results. During this time, 654 households completed the survey. Respondent age varied from 19 to 89, with average age of 52. Eleven percent of the sample had a household income of less than $25,000; 22 percent of the sample had a household income between $25,000 and $50,000; 23 percent of the sample had a household income between $50,000 and $75,000; and 45 percent of the sample had a household income over $75,000. More than 98 percent of respondents had a high school degree or GED, and over half had a bachelor's degree. ALP respondents had more education and income than the broader US population,[3] so our results will likely overstate the levels of financial knowledge, experience, and literacy of the US population at large.

The survey began with an assessment of investment experience. We then asked several questions on the differences between investment advisers and broker-dealers. Next, respondents who used a financial service provider were asked detailed questions about their interactions with their providers. Respondents who did not use a financial service provider were asked why they did not. Finally, we presented respondents with definitions of a broker and an investment adviser, including a description of common job titles, legal duties, and typical compensation. Respondents were then asked to report the likelihood of their seeking services (in general) from a broker or investment adviser, the likelihood of seeking investment advice (in particular) from a broker or investment adviser, and the degree to which they would trust investment advice from a broker or an investment adviser.

We labeled respondents as 'experienced' investors if they held investments outside of retirement accounts, had formal training in finance or investing, or held investments only in retirement accounts but answered positively to questions gauging their financial understanding, such as the nature and causes of increases in their investments, seeking out information about their investments when necessary, and knowing the different investment options available to them. If respondents did not meet these requirements, then we labeled them as 'inexperienced' investors. We used an identical classification method to determine participation in the focus groups. In our sample, about two-thirds of survey respondents were categorized as experienced investors and one-third were categorized as inexperienced investors.

Beliefs about the differences between investment advisers and brokers

We first presented respondents with a series of specific financial services and obligations and asked them to indicate which items applied to any of the following financial service professionals: (*a*) investment advisers; (*b*) brokers; (*c*) financial advisors or financial consultants; (*d*) financial planners; or (*e*) none of the above.[4] Table 7.1 summarizes the survey results, and shows that respondents perceived differences between investment advisers and brokers in terms of services provided, as well as duties and obligations.

Respondents were more likely to report that investment advisers, rather than brokers, provided advice about securities, recommended specific investments, and provided planning services. On the other hand, respondents were more likely to say that brokers, rather than investment advisers, executed stock transactions and earned commissions. Respondents were slightly more likely to report that investment advisers rather than brokers were required to act in the client's best interest and disclose any conflicts of interest. These differences are small in magnitude, but they are statistically significant.

Respondents also tended to report that financial advisors and consultants were more similar to investment advisers than to brokers in terms of

TABLE 7.1 Respondent beliefs about financial service professionals (%)

Does the professional:	Investment advisers	Brokers	Financial advisors or financial consultants	Financial planners	None of these
Provide advice about securities (e.g., shares of stocks or mutual funds) as part of their regular business	80	63	78	63	3
Execute stock or mutual fund transactions on the client's behalf	29	89	28	23	3
Recommend specific investments	83	51	72	50	2
Provide retirement planning	51	12	80	91	2
Provide general financial planning	42	13	80	88	1
Receive commissions on purchases or trades that the client makes	43	96	34	22	1
Typically get paid based on the amount of assets that the client holds	49	40	50	34	12
Act in the client's best interest as required by law	49	42	59	55	19
Disclose any conflicts of interest as required by law	62	58	57	51	18

Notes: Based on 651 respondents.

Source: Authors' calculations based on the ALP survey; see text.

the services provided, compensation methods, and duties. However, as noted in Hung et al. (2008), *financial advisor* and *financial consultant* are titles commonly used by investment advisory-firm employees as well as brokerage-firm employees. Furthermore, we present evidence later that the most common titles of financial service providers that these respondents employ are generic terms, such as *advisor* or *financial advisor*.

Respondents who used financial service providers

In our sample, 47 percent of respondents reported that they used a financial service provider for 'conducting stock market and/or mutual fund transactions' and/or 'advising, management, and/or planning'.[5] These

TABLE 7.2 Respondents who use financial professionals by respondent characteristics (%)

Characteristic	Responding yes
All respondents	47.3
40 and older	50.3
Under 40	33.9
College degree or more	55.4
No college degree	38.8
Household income of at least $75,000	55.0
Household income less than $75,000	40.7
Experienced	59.4
Inexperienced	23.4

Notes: Based on 647 respondents' answers to the question: 'Do you currently use any professional service providers for (*a*) conducting stock market or mutual fund transactions or (*b*) advising, management, or planning?'

Source: Authors' calculations based on the ALP survey; see text.

respondents were more likely than other respondents to be over age 40, have at least a college degree, have household income of at least $75,000, and be an experienced investor (see Table 7.2). Of the 306 respondents who reported using a financial service provider, 73 percent reported receiving professional assistance for advising, management, or planning, and 75 percent reported receiving professional assistance for conducting stock market or mutual fund transactions. Initially, almost half reported using professional assistance for both types of services. In discussing the services they received, respondents were given another opportunity to report whether their financial service professional provided both types of services. In response to that follow-up question, we found that more than 70 percent of the reported financial service professionals provided both types of services.

We also asked respondents who reported they used a financial service provider whether there was a specific person, rather than a firm, that provided these financial services. Almost 81 percent of respondents personally interacted with an individual professional, and of those respondents, 31 percent personally interacted with more than one individual professional. Just over one-third (35 percent) reported employing at least one firm where they did not interact regularly with a specific person. To better assess whether respondent experiences differed depending on whether they interacted with a specific individual rather than a firm, we distinguish between these experiences when presenting results.

Job titles and firm types of financial service providers

Respondents who reported that they used a specific person, or an individual professional, were then asked for that person's title (or brief job description). Respondents gave 449 titles for 323 individual professionals.[6] The vast majority (248) of these individual professionals reportedly provided both advisory and brokerage services, whereas forty-five of these individual professionals reportedly provided brokerage services but not advisory services, and thirty-four reportedly provided advisory services but not brokerage services. Respondents reported a wide variety of titles that their financial service providers used. Summarized in Table 7.3, the most commonly reported title is *financial adviser* or *financial advisor*, regardless of the type of service provided by the individual professional. In fact, if these titles are combined with *financial consultant* and *advisor*, they account for almost one-quarter of all listed titles. *Financial planners* were listed forty-four times and Certified Financial Planners (CFPs) were listed twenty-one times. *Broker*, *stockbroker*, or *registered representative* was used thirty-eight times, and *investment adviser* or *investment advisor* was used twenty-two times.

For any given title, the individual professional was most likely to be reported as offering both types of services. Reported titles for individual professionals who provided only advisory services or only brokerage services suggest some confusion on respondents' parts, although these num-

TABLE 7.3 Professional titles most commonly reported by respondents

Title	All individual professionals	Provide advisory services only	Provide brokerage services only	Provide both types of services
Advisor	11	1	1	9
Banker	21	2	8	11
Broker, stockbroker, or registered representative	38	0	8	30
CFP	21	3	3	15
Financial adviser or financial advisor	78	7	11	60
Financial consultant	25	2	0	23
Financial planner	44	6	1	37
Investment adviser or investment advisor	22	3	3	16
President or vice president	20	0	2	18

Notes: 449 titles were reported. Entries indicate the number of times that the title was reported.

Source: Authors' calculations based on the ALP survey; see text.

bers were small. For example, of the twenty-two individual professionals with a reported title of *investment adviser* or *investment advisor*, respondents reported that three provided brokerage services only. Furthermore, recall that responses to the questions on beliefs about financial service providers indicated that respondents viewed financial advisors or financial consultants as being more similar to investment advisers than to brokers. But when asked about job titles and service provided, responses indicated that financial advisors were more likely to provide brokerage services only than to provide advisory services only. Lastly, we note that twenty-six responses were left blank or explicitly stated that the respondent did not know the individual professional's job title or job description.

Respondents who worked with at least one individual professional were asked about the kinds of firms that employed the individual professional who provided financial services. Respondents were then asked to check all that applied: investment advisory firm, brokerage firm, bank, or other. The order of the first two categories was randomized between subjects. For firms that are associated with an individual professional, the most common response to the type-of-firm question was for the first two categories to be checked—that is, both investment advisory firm and brokerage firm (see Figure 7.1). We refer to these firms as *dual investment advisory-brokerage firms*.

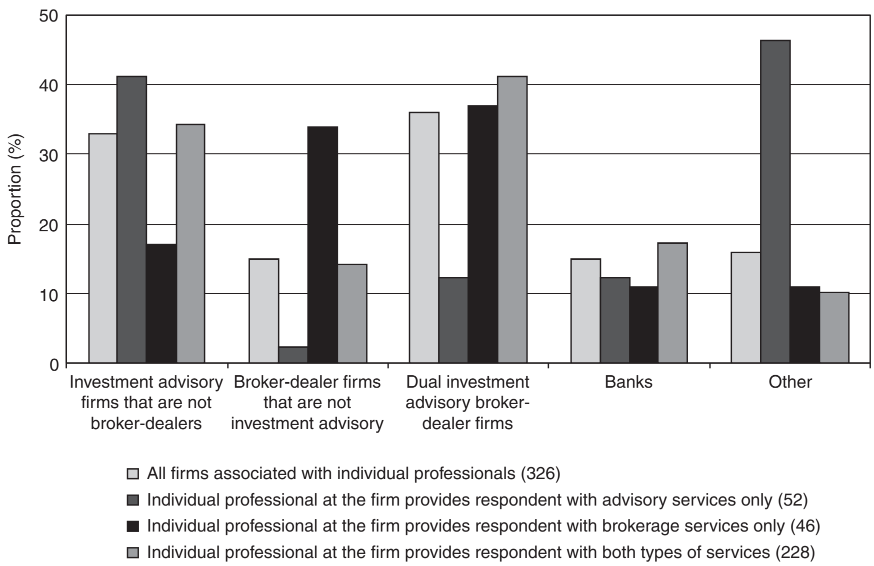

Figure 7.1 Types of firms that employ individual professionals

Source: Authors' calculations; see text.

The second most common response is for the category of investment adviser to be checked but not the brokerage category to be checked. We refer to these firms as *investment advisory firms that are not broker-dealers.* There were fifty-two other firm categories checked, and respondents specified thirty-seven of them. The most commonly mentioned other type of firm was insurance firm (ten), and the second most commonly mentioned type of firm was accounting firm (seven).

Respondents who did not interact with a specific person were asked to report what kinds of firms they used for financial services. As before, respondents were asked to check all that applied: investment advisory firm, brokerage firm, bank, or other, where the order of the first two categories was randomized between subjects. For firms not associated with an individual professional, the most common response to the type-of-firm question was for the brokerage category to be checked, but not the category for investment advisers to be checked. We refer to these firms as *brokerage firms that are not investment advisers.* The second most common is investment advisory firms that are not broker-dealers (see Figure 7.2).

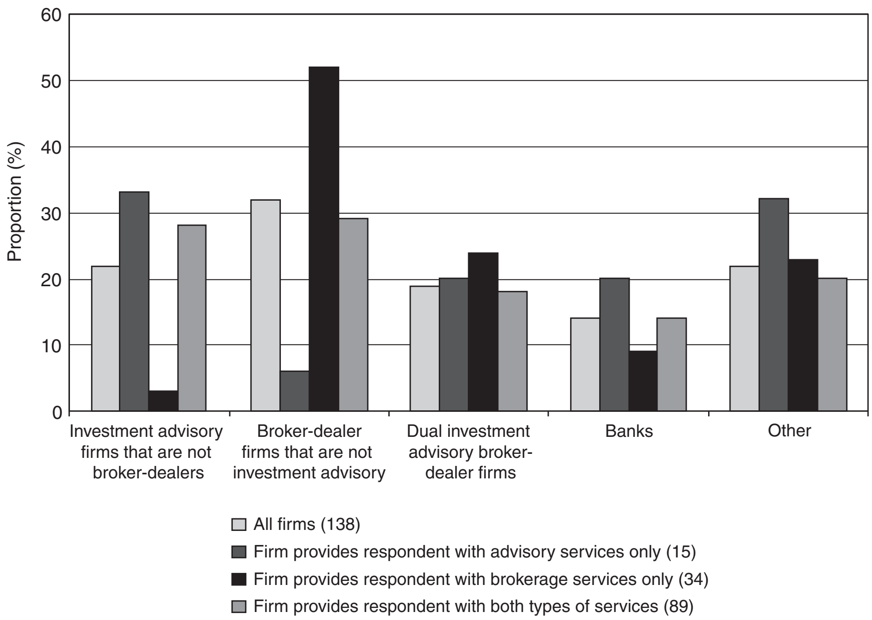

Figure 7.2 Types of firms used that are not associated with individual professionals
Source: Authors' calculations; see text.

Experiences with financial service providers

We also asked respondents detailed follow-up questions on the first individual professional or the first reported firm not associated with an individual professional.[7] We received detailed responses on 246 individual professionals and eighty-five firms. Comparing these professionals and firms about which respondents gave us detailed information, we found that the firms were less likely to provide both advisory and brokerage services, according to our respondents. Of the 246 individual professionals about whom respondents gave us detailed information, 12 percent provided advisory services only, 11 percent provided brokerage services only, and 76 percent provided both types of services. Of the eighty-five firms about which respondents gave us detailed information, 18 percent provided advisory services only, 29 percent provided brokerage services only, and 53 percent provided both types of services.

Methods of payment for financial services

Figure 7.3 shows what methods of payment respondents used for advisory or brokerage services: commission, rate (hourly, monthly, or annual), flat fee, a fee determined by a percentage of assets, or other. The most com-

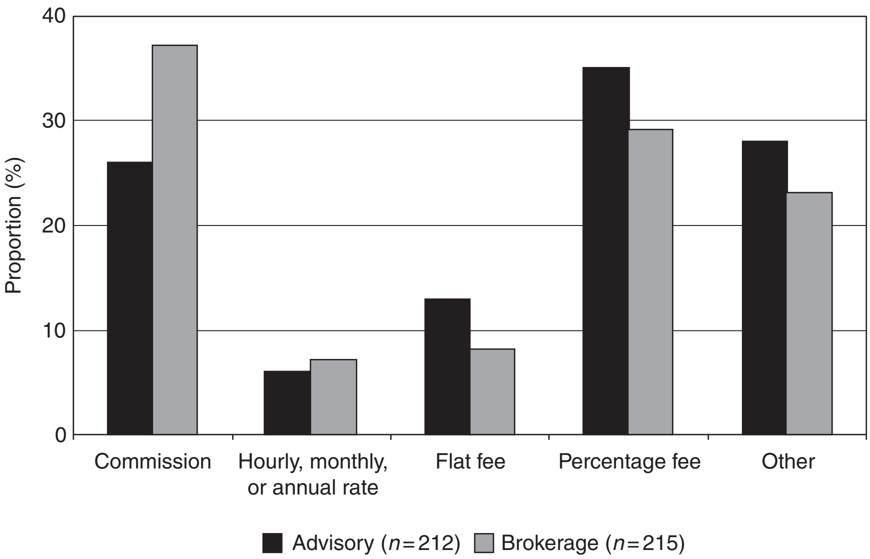

Figure 7.3 Methods of payment to individual professionals for financial services
Source: Authors' calculations; see text.

monly reported compensation method to individual professionals for brokerage services was commission (37 percent), and the most commonly reported compensation method for advisory services was a fee determined by percentage of assets (35 percent). When asked to estimate their annual expenditure for the different types of services, respondents whose individual professional provided advisory services ranged from $0 to $30,000, with an average of $1,374. Answers from respondents whose individual professional provided brokerage services ranged from $0 to $21,500, with an average of $1,131. Yet the median annual expenditure on advisory services from individual professionals was $125, and the median annual expenditure on brokerage services from individual professionals was $200. The large difference between average and median expenditure indicates that a small proportion of respondents reported paying a large amount for these services. Indeed, 10 percent of the responses on annual expenditure for advisory services from an individual professional were at least $3,000. Likewise, 10 percent of the responses on annual expenditure for brokerage services were at least $2,400.

Many respondents were confused about the methods of payment or the type of firm with which their individual professional was associated. For example, eighty-four respondents indicated that they received advisory services (either alone or in conjunction with brokerage services) from an investment advisory firm that was not also a brokerage firm. Of these respondents, 19 percent reported that they paid for these advisory services based on a percentage fee, and 22 percent indicated that they paid commission for advisory services. However, Hung et al. (2008) found that 97 percent of SEC-registered investment advisers that were not registered broker-dealers reported that they were compensated by asset-based fees, and only 10 percent reported that they received commissions.[8] Finally, fourteen respondents did not answer the estimated annual expenditure question for advisory services, and forty-one reported that they paid $0. For brokerage services, eighteen respondents did not answer the estimated annual expenditure question, and thirty-four reported that they paid nothing.

Respondents also reported that the most common form of compensation for brokerage services for firms, as opposed to individual professions, was commission and, for advisory services, was 'Other' (see Figure 7.4). The most common explanations for other responses were that the respondent did not pay for the service (six responses) or did not know what he or she paid for the service (four responses). When asked to estimate their annual expenditures for the services provided by firms, rather than directly from individual professionals, the respondents' answers ranged from $0 to $5,700, with an average of $278. The answers from respondents with firms providing brokerage services ranged from $0 to $8,000, with an

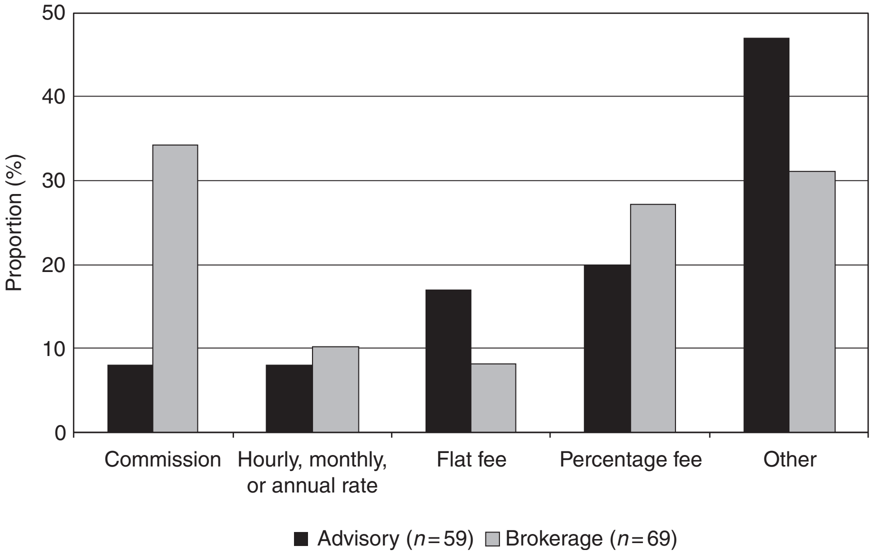

Figure 7.4 Methods of payment to firms for professional services
Source: Authors' calculations; see text.

average of \$476. For advisory services, eight respondents did not answer the estimated annual expenditure question, and twenty-one reported that they paid \$0. For brokerage services, five respondents did not answer the estimated annual expenditure question, and fourteen reported that they paid nothing.

How respondents located their financial service provider

Regardless of the types of services received, the most common way in which respondents found their current individual professional was by referral from a friend or family. The second most common way was by professional referral (see Table 7.4). When asked about how respondents found the current firm that they employed for financial services, the most common response was 'Other'. Of the thirty-two other responses, there were nineteen explanations. The most frequently mentioned explanation (six responses) was that the respondent found the firm through their place of work. The second most common method was by referral from a friend or family (see Table 7.5).

TABLE 7.4 Methods of locating individual professionals (%)

Method	All responses	Advisory service only	Brokerage service only	Both types of services
Professional referral	30.5	23.3	13.8	34.4
Referral from friend or family	45.6	43.3	34.5	47.8
Mailing	3.3	6.7	0.0	3.3
Print ad	3.8	0.0	6.9	3.9
Television ad	0.8	0.0	3.4	0.6
Internet	1.3	0.0	6.9	0.6
N	239	30	29	180

Source: Authors' calculations based on the ALP survey; see text.

TABLE 7.5 Methods of locating financial service firms (%)

Method	All responses	Advisory service only	Brokerage service only	Both types of services
Professional referral	18.1	14.3	12.0	22.7
Referral from friend or family	28.9	28.6	28.0	29.5
Mailing	2.4	0.0	0.0	4.5
Print ad	10.8	7.1	8.0	13.6
Television ad	6.0	0.0	4.0	9.1
Internet	8.4	0.0	12.0	9.1
Other	36.1	50.0	44.0	27.3
N	89	14	25	44

Source: Authors' calculations based on the ALP survey; see text.

Length of relationship and satisfaction with financial service provider

In general, respondents reported that they had been working with the current individual professional for several years. When respondents were asked how long they had been working with their current individual professional, 34 percent reported at least ten years, 26 percent reported five to ten years, 32 percent reported one to five years, and 8 percent reported less than one year. For respondents who received only advisory services and for respondents who received both types of services from their individual professionals, the most common length of relationship was more than ten years. For respondents who received brokerage services only, ten respondents reported that the length of the relationship was between one

TABLE 7.6 Length of time with same individual professional and customer satisfaction (%)

	All responses	Advisory service only	Brokerage service only	Both types of services
About how long have you been doing business with this individual?				
Less than 1 year	7.5	20.0	6.9	5.6
1–5 years	31.8	23.3	34.5	32.8
5–10 years	26.4	20.0	27.6	27.2
More than 10 years	34.3	36.7	31.0	34.4
I am very satisfied with the service that I receive from this individual.				
Strongly disagree	7.1	0.0	6.9	8.3
Disagree	2.1	3.3	3.4	1.7
Neither agree nor disagree	15.9	26.7	10.3	15.0
Agree	41.4	43.3	62.1	37.8
Strongly agree	33.5	26.7	17.2	37.2
I trust that this individual acts in my best interest.				
Strongly disagree	7.1	0.0	3.4	8.9
Disagree	2.5	6.7	6.9	1.1
Neither agree nor disagree	15.1	26.7	17.2	12.8
Agree	35.1	33.3	51.7	32.8
Strongly agree	40.2	33.3	20.7	44.4
I believe that this individual provides me with a valuable service.				
Strongly disagree	7.5	0.0	6.9	8.9
Disagree	1.7	0.0	6.9	1.1
Neither agree nor disagree	11.7	20.0	17.2	9.4
Agree	41.0	53.3	51.7	37.2
Strongly agree	38.1	26.7	17.2	43.3
N	239	30	29	180

Source: Authors' calculations based on the ALP survey; see text.

and five years, and nine respondents reported that the length of the relationship was more than ten years (see Table 7.6).

Most respondents were satisfied with their individual professionals: at least 70 percent reported that they agreed or strongly agreed with the statements: 'I am very satisfied with the service that I receive from this individual; I trust that this individual acts in my best interest; I believe that this individual provides me with a valuable service.' Respondents who had worked with their individual professional for at least ten years expressed even greater satisfaction: 78 percent agreed or strongly agreed that they were very satisfied with the service that they received, 83 percent agreed or strongly agreed that their individual professional acted in their best inter-

TABLE 7.7 Length of time with same firm and customer satisfaction (%)

	All responses	Advisory service only	Brokerage service only	Both types of services
About how long have you been doing business with this firm?				
Less than 1 year	7.2	7.1	12.0	4.5
1–5 years	25.3	21.4	28.0	25.0
5–10 years	25.3	7.1	32.0	27.3
More than 10 years	42.2	64.3	28.0	43.2
I am very satisfied with the service that I receive from this firm.				
Strongly disagree	7.2	7.1	4.0	9.1
Disagree	1.2	0.0	4.0	0.0
Neither agree nor disagree	19.3	21.4	24.0	15.9
Agree	38.6	35.7	32.0	43.2
Strongly agree	33.7	35.7	36.0	31.8
I trust that this firm acts in my best interest.				
Strongly disagree	6.0	7.1	4.0	6.8
Disagree	2.4	0.0	8.0	0.0
Neither agree nor disagree	31.3	28.6	40.0	27.3
Agree	31.3	35.7	20.0	36.4
Strongly agree	28.9	28.6	28.0	29.5
I believe that this firm provides me with a valuable service.				
Strongly disagree	7.2	7.1	4.0	9.1
Disagree	1.2	0.0	0.0	2.3
Neither agree nor disagree	19.3	21.4	20.0	18.2
Agree	34.9	28.6	36.0	36.4
Strongly agree	37.3	42.9	40.0	34.1
N	83	14	25	44

Source: Authors' calculations based on the ALP survey; see text.

est, and 82 percent agreed or strongly agreed that they were being provided with a valuable service (see Table 7.7).

As we found with the results on individual professionals, respondents tended to be satisfied with their firms. At least 70 percent of respondents reported that they agreed or strongly agreed with these statements: 'I am very satisfied with the service that I receive from this firm; I trust that this firm acts in my best interest; I believe that this firm provides me with a valuable service.' When we condition on the type of service provided, one category in which respondents indicate a lower level of satisfaction is the degree to which they trust that the firm that provides brokerage services acts in their best interest. In this case, only 48 percent of respondents agreed or strongly agreed with the statement. Longer-term relationships were also rated more positively.

TABLE 7.8 Reasons given for not using a financial professional (%)

Reason	Brokerage and advisory services	Brokerage services	Advisory services
No money for investments	47.1	35.5	17.6
Too expensive	13.2	9.7	20.6
Too hard to choose one	6.2	0.0	2.9
Do not need assistance with financial decisions	21.5	12.9	52.9
Had one and did not like him, her, or the firm	8.2	0.0	11.8
N	340	31	34

Source: Authors' calculations based on the ALP survey; see text.

Reasons not to use a financial service provider

We asked respondents who reported that they did not use a financial service provider for the reasons that they did not employ one. Respondents who used a financial service provider only for advisory services were asked why they did not use a financial service provider for brokerage services. Likewise, to respondents who used a financial service provider only for brokerage services, we asked why they did not use a financial service provider for advisory services. The results are summarized in Table 7.8.

Respondents were given five choices for why they might not employ a financial service provider, in addition to an 'Other' category, and they were asked to choose all that applied: no money for investments; too expensive; too hard to choose one; did not need assistance with financial decisions; or had one and did not like him, her, or the firm. For respondents who did not use a financial service provider at all, the most common answer (47 percent) was 'No money for investments'. For respondents who did not use a financial service provider for brokerage services, the most common specified reason (36 percent) was 'No money for investments'. Among respondents who do not use a financial service provider for advisory services, the most common reason (18 percent) is that the respondent does not 'need assistance with [his or her] financial decisions'.

Relative inclination to seek services from brokers or investment advisers

Respondents were then presented with definitions of broker and investment adviser, including a description of common job titles, legal duties, and typical compensation. We first asked them: 'On a scale from 0 to 100, what do you

TABLE 7.9 Inclination to seek future services from investment advisers and brokers (%)

	Investment adviser			Broker		
	Mean	Median	*N*	Mean (%)	Median	*N*
Percent chance of seeking *services* from [investment adviser/broker] in the next five years	37.1	25	634	36.6	20	637
Percent chance of seeking *investment advice* from [investment adviser/broker] in the next five years	51.9	50	454	47.7	50	458
I would trust investment advice from [investment adviser/broker] (1 = strongly disagree, 5 = strongly agree)	3.4	3	635	3.1	3	637

Source: Authors' calculations based on the ALP survey; see text.

think is the percent chance that you will seek (or continue to seek) services from a [broker/investment adviser] in the next five years?' For respondents who reported a positive probability, we followed up with a question on investment advice: 'On a scale from 0 to 100, what do you think is the percent chance that you will seek (or continue to seek) investment advice from a [broker/investment adviser] in the next five years?' Last, we asked respondents to rate the degree to which they agreed with the following statement: 'I would trust investment advice from a [broker/investment adviser].'

As shown in Table 7.9, respondents were roughly equally likely to seek services in general, and investment advice in particular, from investment advisers and broker-dealers. On average, respondents were equally likely to seek services, in general, from investment advisers and brokers, but the median response was slightly higher for services from an investment adviser (25 percent versus 20 percent). Almost 29 percent of respondents reported no chance that they would seek services from a broker, and 28 percent of respondents reported no chance that they would seek services from an investment adviser. Among respondents who reported a positive probability that they would seek services from a broker or an investment adviser, the median response indicated an equal willingness to seek investment advice from either.

Assistance respondents seek for financial matters

We asked all respondents, 'What kind of professional assistance with financial matters would you find most helpful at this point in your life?', with the following options: asset management, college-saving planning, debt consolidation or management, developing a budget and saving plan, estate planning, executing stock or mutual fund transactions, general financial planning, investment advising, retirement planning, or other. A majority of respondents (62 percent) indicated they would like assistance with retirement planning. Many respondents would also like assistance with investment advising (41 percent), financial planning (38 percent), and estate planning (35 percent). We replicated the analysis conditioning on age, education, income, investment experience, and whether the respondent reported using a financial service provider.[9] Across all groups, the most commonly selected option was 'retirement planning'. Across all groups, the second most common was 'investment advising', except for respondents who did not have a college degree, respondents who did not report using a financial service provider, or respondents who were classified as inexperienced. For the first three of those groups, the second most commonly selected option was 'general financial planning'. For the last group, respondents classified as inexperienced, the second most commonly selected option was 'developing a budget and savings plan'.

Focus groups

Focus groups allow for in-depth and interactive discussion of the topics, and they also allow moderators to follow up on beliefs and understanding behind responses. Although focus-group participants are not nationally representative and data collected during focus groups are only qualitative, this method often provides researchers with important evidence on the more nuanced issues surrounding topics. To illustrate the understanding learned from this approach, we first discuss our methodology, followed by impressions from the focus groups regarding the financial service industry. We then describe participants' financial decision-making and experience with financial service providers. Last, we examine some of the perceived differences between investment advisers and broker-dealers.

Methods

We conducted six focus groups of ten to twelve participants each, representing both experienced and inexperienced investors. As with survey respondents, focus-group participants were deemed to be experienced investors if they held investments outside of retirement accounts, had formal training in finance or investing, or held investments only with retirement accounts but answered positively to questions eliciting their self-assessed financial understanding (such as the nature and causes of increases in their investments, seeking out information about their

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investments when necessary, and knowing the different investment options available to them). Participants who did not meet these requirements were deemed inexperienced investors.

The sixty-seven participants ranged from 22 to 77 years of age, with two-thirds of participants older than 40. The mix of racial and ethnic background included forty-four white but not Hispanic, eighteen black, two Hispanic, and three Asian participants. The focus groups were held in Alexandria, Virginia and Fort Wayne, Indiana in September and October 2007. We employed the services of outside firms to recruit our participants. For the Virginia focus groups, we used a recruiting firm that maintained a database of approximately 17,000 individuals from the Washington, DC, metropolitan area, including northern Virginia and parts of Maryland. For the Indiana focus groups, we used a local recruiting firm that maintained a database of approximately 35,000 individuals, mainly from Allen County, Indiana, with a small percentage (9–10 percent) of individuals who reside in counties immediately adjacent to Allen County. Each location included two groups of experienced investors and one group of inexperienced investors. The approximate ratio of two-thirds experienced investors and one-third inexperienced investors is similar to the ratio among the ALP respondents. We asked them a range of questions about their level of understanding and experience with the financial services industry. We also presented them with sample advertisements from both broker-dealers and investment advisers, and asked what types of products and services and levels of interaction they expected from each.

Investment experience

Almost all participants held investments in retirement accounts, primarily through their employers. Many had investments outside of retirement accounts, primarily in mutual funds, and some held individual stocks and annuities. A few individuals who were particularly uncertain about what to do with their money had put their saving into money-market accounts (MMA) and certificates of deposit (CDs). These participants felt that they had received poor financial advice in the past and were unsure how to invest it, so they went with the perceived security of MMAs and CDs. Participant age ranged from 22 to 77 years, and investment experience ranged from 2 to 40 years. Most participants described their level of financial knowledge as low, including many who had been investing for several years. About 10 percent of participants considered their level of financial knowledge to be good or advanced. Participants attributed their lack of knowledge to having little interest in finances, lack of time to learn and keep up, and the fact that financial literature is complicated and confusing. Some mentioned that conflicting information left them unsure about which sources to trust.

General impressions of the financial service industry

When asked about their general views of the financial service industry, participants tended to characterize the industry as complicated. As with any industry, people felt that there were both honest and dishonest individuals within the financial service industry. Some noted that recent corporate scandals (e.g., WorldCom and Enron) led the public to view the financial services industry with more skepticism. As it is an industry based on trust, many participants noted that they did not trust the industry. Many of those with investments acknowledged that they were unsure what they were being charged for the investments they currently held. They believed that there were hidden fees and that investment professionals would not provide them with certain information unless they specifically asked for it. They believed that one must know the right questions to ask or end up at a disadvantage. When asked about financial service advertisements they might have seen, participants believed that advertisements of investment professionals tried to make people think it was easy to get started and that the company would work for its clients to help them attain a certain lifestyle.

Participants cited several reasons they saw as to why people failed to invest. These included the fact that they thought it was necessary to have a large amount of disposable income to invest; they had no money to invest; they feared losing their money in investments; they lacked knowledge about investing; and they believed that the financial service industry was too complex to navigate.

Investor decision-making and experience with financial service professionals

Participants reported obtaining information about financial products and services from a variety of sources, including the Internet, friends and family, financial magazines, television, prospectuses, presentations at work, and financial service professionals (including advisers, accountants, insurance agents, and their bank). Roughly half of participants reported that they used a financial service provider. Those who had investments but did not use a financial service provider explained that they trusted themselves as much as a professional with their money.

In fact, trust of the individual financial service professional was the most-cited feature of what investors sought, cited as more important than trust of the firm for which that individual worked. Many participants had a preference for older, established firms, because they showed staying power and the ability to ride out hard times. Most participants currently working with a financial service provider located that provider through personal or professional referral. When we asked participants who did not currently use a financial service provider how they would find one if they chose to employ one in the future, referral was the most common response. Although the majority of those who used a financial service provider were happy with the relationship and the service, several participants did note that they were unsatisfied, because of lack of personal interaction (these comments were similar to those reported by ALP respondents). Many respondents had gone years without hearing from their financial service providers, although some recognized that they were partly responsible for this lack of communication. Others noted that their financial service provider did not seem to do much.

Participants were also asked what they liked about their relationship with their financial service provider, if they currently used one; otherwise, they were asked what they would seek in a relationship with a financial service provider if they were to employ one. Some participants preferred a very 'hands-off' relationship, stating that they had neither the inclination nor the time to follow the markets and were happy to turn that job over to a professional. Other participants thought that they would like to be a partner in their financial decisions and to have a say in what was done with their money. However, these participants tended to realize that there was much about the financial service industry that they did not know or understand, so it would be important to have a financial service provider who would take the time to educate them about the market and the various products available. Many participants felt that, because their assets were too modest, they would not be of interest to the majority of financial service providers to spend the necessary amount of time to work with and educate them.

Contact with investment professionals

Some participants said that they would prefer to communicate with an individual professional via the phone, while others preferred face-to-face meetings or email. In an ideal relationship, participants felt that they would want to meet with their representatives more frequently at first (monthly), and then on a quarterly or semi-annual basis after they felt comfortable in the relationship. Participants who felt fairly knowledgeable about their investments sought less contact with their investment professional.

Desired services

Of those who sought professional help, all cited retirement that would involve not only saving for retirement but also determining how the funds should be spent and invested during retirement. The other desired services that participants mentioned most were education planning, insurance planning, and estate planning. A few participants noted needing help with budget planning and saving to buy a house. Participants were divided over whether it was better to have all their investments handled by one firm, or to have several firms helping them. Convenience was an advantage to having one firm: the individual professional could see the whole financial picture and better advise the client and reduce the amount of paperwork to track. Other participants wanted to spread their investments across a couple of firms, believing that this would reduce their risks. They also noted that some firms specialized in certain types of investments and that it might be better to play to the strengths of certain firms. Still others preferred the idea of entrusting some of their money to financial service providers but also investing a portion of their money on their own.

Perceived differences between investment advisers and brokers

Focus-group participants displayed some confusion regarding the role of investment advisers and brokers, as observed with ALP respondents; focus-group discussion helped illuminate the sources of confusion. To assess participant levels of understanding regarding the roles of various financial service professionals, we administered a short questionnaire prior to the detailed discussion on the distinction between investment advisers and brokers, to capture their understanding on coming into the focus-group session and not reflect anything they might learn during the focus-group session. Participants were presented with a series of specific services and obligations and were asked to indicate which items applied to the following financial service professionals: investment advisers, brokers, financial advisors, financial consultants, financial planners, or none of the above. Table 7.10 provides the results of that questionnaire,[10] and it indicates that focus-group responses were quite similar to those of the household survey.

The main differences between focus-group participants and survey respondents were that a much smaller share of focus-group participants (5 percent) believed that investment advisers received commissions than did survey respondents (43 percent). Focus-group participants were more likely to report that both investment advisers and brokers were required to act in the client's best interest (64 and 63 percent, respectively) than did

TABLE 7.10 Participants' beliefs about financial service professionals (%)

Does this professional:	Investment advisers	Brokers	Financial advisors or consultants	Financial planners	None of these
Provide advice about securities (e.g., shares of stocks or mutual funds) as part of their regular business	85	61	76	63	0
Execute stock or mutual fund transactions on the client's behalf	27	84	22	18	0
Recommend specific investments	93	46	67	46	0
Provide retirement planning	39	12	81	91	0
Provide general financial planning	33	16	79	91	0
Typically receive commissions on purchases or trades that the client makes	5	96	43	33	0
Get paid based on the amount of assets that the client holds	51	57	45	19	6
Act in the client's best interest, as required by law	64	63	58	57	18
Disclose any conflicts of interest, as required by law	60	70	61	72	18

Notes: Based on sixty-seven participants.

Source: Authors' calculations based on focus-group survey; see text.

ALP respondents (49 and 42 percent, respectively). Furthermore, focus-group participants were more likely than survey respondents to report that brokers were required to disclose any conflicts of interest. In fact, focus-group participants were more likely to report that brokers, rather than investment advisers, must disclose conflicts, whereas ALP respondents were more likely to report that investment advisers must disclose conflicts.

Reactions to investment advisers' and broker-dealers' advertisements

The first set of advertisements presented to focus-group participants was general advertisements from actual firms taken from magazines, with identifying information or marks stripped. Firm A's brokerage services advertisement stressed the importance of building a relationship with one's financial consultant based on trust. The advertisement further described financial consultants' expertise and research tools (with fine print detailing that the research tools provide general, not personal, advice). The advertisement specifically mentioned mutual funds and stocks. Firm B's advertisement, taken from an investment advisory firm, stressed the importance of careful planning so that the reader's estate would be left to his or her beneficiaries, rather than to the Internal Revenue Service (IRS). This advertisement also highlighted the firm's experience and expertise. The advertisement specifically mentioned philanthropy, asset management, and sophisticated wealth-transfer strategies.

In discussing what appealed to them about Firm A, many participants mentioned that they liked the trust message and that the advertisement implied that all of its employees were well trained. A commonly mentioned dislike of the firm was the fine print detailing that the research tools were not personal advice. Regarding Firm B, many participants mentioned that they believed that they thought that they could benefit from its services, such as asset management. However, given the tone of the advertisement, many participants also thought that they did not have enough money to be a client at Firm B.

Inclination to seek services from investment advisers or brokers

Participants were presented with fact sheets on investment advisers and brokers, which included the same information as the descriptions given to ALP survey respondents: definitions of *broker* and *investment adviser*, including a description of common job titles, legal duties, and typical compensation. Even after being presented with fact sheets, participants were still confused by the titles. They noted that the common job titles for investment advisers and broker-dealers were so similar that people were easily confused about which type of professional they were consulting. Some participants said they knew which type of investment professional they had, but most did not. Participants expressed interest in the fact that brokers have to be certified and investment advisers do not. Several interpreted this to mean that advisers were less qualified than the brokers.

Many respondents did not understand the term *fiduciary* and whether fiduciary was a higher standard than suitability. Some participants did not think that the legal requirements for either investment advisers or brokers were stringent enough. Several participants mentioned that, if an investment adviser made a costly mistake with a client's money, they thought that it would be difficult to prove that the adviser was not acting in the client's best interest. Other participants did not like that brokers had to recommend products that were suitable for them. They thought that *suitable* was too vague a term and that it was not clear how the broker would determine suitability. Many participants also noted that investment advisers had to disclose conflicts of interest, while brokers did not.

Conclusion

Our review of the literature and our survey evidence shows that many people do not understand key distinctions between investment advisers and broker-dealers—their duties, the titles they use, the firms for which they work, or the services they offer. Nevertheless, people tend to have relatively long-term relationships with their financial service professionals, expressing high levels of satisfaction with their services. This satisfaction was often reported to arise from the personal attention the investor received. Unfortunately, we lack evidence on how levels of satisfaction varied with financial returns, but we know from focus-group participants with investments that many were unsure about the fees they paid for their investments. Additionally, people are unclear regarding the roles of broker-dealers and investment advisers, commenting that 'We do it all' advertisements make it difficult to discern broker-dealers from investment advisers. Furthermore, even though we sought to explain fiduciary duty and suitability in plain language, respondents struggled to understand the differences between the standards of care. Even after explaining that a fiduciary duty is generally a higher standard of care, focus-group participants expressed doubt that the standards are different in practice.

Despite this confusion, however, most respondents and participants expressed satisfaction with their financial service providers. The most commonly cited reasons for the satisfaction of survey respondents were their professional's attentiveness and accessibility, mentioned even more often than expertise. Although focus-group members also mentioned these qualities, they more often mentioned trust. Finally, respondents and participants often indicated that they recognized the value of investment advice. Those who currently received investment advice often reported that they found the service to be valuable. Many of those who did not currently receive investment advice expressed a desire to receive these services, but they were concerned that their relatively low amount of investable assets made it difficult to obtain these valuable services.

Endnotes

1 This chapter is drawn from Hung et al. (2008).

2 As of this writing, a consolidated House and Senate financial regulatory reform bill had not passed. The House of Representatives version of a financial regulatory reform bill passed in December 2009. This legislation directs the SEC to adopt rules that apply a standard of conduct to broker-dealers and investment advisers who provide personalized investment advice to retail customers to act in the best interest of their customers (a fiduciary duty). The Act goes on to say that broker-dealers are not subject to a continuing duty of care or loyalty to the customer, after providing personalized investment advice about securities. Broker-dealers are required to disclose any material conflicts of interest (such as the sale of only proprietary products) and obtain consent from the customer. In general, the SEC is directed to require simple, clear disclosures to investors regarding their relationship with their financial professionals, including any material conflicts of interest. The SEC is also directed to adopt rules, where appropriate, to restrict or prohibit sales practices, conflicts of interest, and compensation schemes by broker-dealers and investment advisers that are contrary to investors' interests. The Senate Banking Committee proposed the 2010 Restoring American Financial Stability Act. This legislation calls for a study by the SEC on whether brokers should be subject to the same fiduciary standard that applies to registered investment advisers. Under the bill, the SEC would have one year to report to Congress on what it finds and another year to implement any necessary changes.

3 According to the March 2007 Current Population Survey, 85 percent of Americans aged 18 and older had at least a high school diploma or GED, and 26 percent had at least a bachelor's degree. The distribution for US household income is 22 percent with less than $25,000; 27 percent greater than $25,000 but less than $50,000; 20 percent between $50,000 and $75,000; and 31 percent greater than $75,000. See US Census Bureau (2007).

4 Between subjects, we randomly varied the order of *broker* and *investment adviser* as they appeared on the computer screen.

5 When we posed the question, 'Do you currently use any professional service providers for (*a*) conducting stock market or mutual fund transactions or (*b*) advising, management, or planning?' we randomly varied the order of the services between subjects as the question appeared on the computer screen.

6 Some respondents provided more than one title for an individual professional (e.g., financial planner, stockbroker, and insurance agent).

7 The frequency distributions for these first individual professionals are similar to those for all individual professionals in the previous section. Likewise, for the first firm reported, the frequency distribution of firm types is similar to those for all firms reported. For further details, see Hung et al. (2008).

8 An alternative explanation for this inconsistency could be that the firms that our respondents used were state-registered rather than SEC-registered firms, and state-registered firms are less likely than SEC-registered firms to charge asset-based fees.

9 Complete results are available from the authors by request.

[10] A data appendix (available on request) provides a breakdown of questionnaire responses by age, education, location, investment experience, and whether the participant has a financial service provider.

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