The Market for Financial Advisers

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Pension Research Council Symposium
May 3, 2012

Our Paper

- We discuss the market for financial advisers, focusing on issues relating to advice provided to people saving for retirement.
- We also discuss financial advice provided to pension plan sponsors.

Benefits of Financial Advice

- Studies have shown that many people are financially unsophisticated.
- For this reason, many would benefit from financial advice.
- The Department of Labor estimates that pension participants save billions of dollars a year in financial mistakes avoided due to financial advice.

What is Financial Advice?

- Financial advice can be provided by computer programs, printed material, advertisements, or direct contact with a financial adviser.
- We focus on financial advice provided directly by a financial adviser.
- The legal definition of financial advice, and the level of protection provided to the client, is a major issue, which we discuss later.

Advisers’ Employers

- Financial advisers can work for:
  - Mutual fund companies
  - Financial advisory companies
  - Banks
  - Brokerage companies
  - Insurance companies
  - Accounting firms

Advisers’ Education

- Advisers can be
  - MBAs
  - Accountants
  - Economists
  - Attorneys
  - Other educational backgrounds

Advisers' Certifications

- Advisers can obtain a wide range of certifications (from a variety of organizations):
  - Certified Financial Planner (CFP Board)
  - Chartered Financial Analyst (CFA Institute)
  - Chartered Financial Counselor (Investment Adviser Association)
  - Personal Financial Specialist (American Institute of CPAs)
  - Chartered Financial Consultant (American College)

Types of Fees Advisers Charge

- Percent of account balance
- Commissions on insurance or financial products
- Combination of fees on account balances and commissions
- Hourly rate
- Flat fee
- Performance-based fee

Exclusions on Clientele

- Advisers charging fees based on assets typically set minimum asset amounts, effectively excluding many people.
- Many companies have minimums of $250,000 or higher.
- In 2007, the median holdings of stock outside of retirement plans of households aged 45-54 with stock was $45,000.

Conflicts of Interest

- Conflicts of interest can arise when an adviser’s compensation varies depending on what advice he provides.
- For example, an adviser may recommend purchasing higher cost funds, more aggressive trading, rolling over a 401(k), or saving more because such advice could raise his compensation.

Conflicts of Interest (2)

- Conflicts of interest affecting 401(k) participants can occur at five points:
  - When plan sponsors select investment options
  - When participants decide whether to invest above the match level in the plan or outside the plan
  - When participants choose investment options
  - When participants leave an employer and are encouraged to rollover to an IRA
  - When participants make investment choices for an IRA

Investment Advisers as Fiduciaries

- Investment Advisers Act
  - Anyone compensated for providing advice related to investments in securities
  - Exception: broker-dealers whose advice is incidental and who do not receive ‘special compensation’
- ERISA
  - Anyone compensated for providing advice related to the investment of benefit plan assets
  - Exception: advice that is not given on a ‘regular’ basis or is not according to a mutual agreement it will serve as the primary basis for advice

Obligation of Fiduciary Advisors

- To provide advice taking into account only the best interest of the client
  - Advisers Act allows conflicted advice if disclosures are made
- The standard for advisers who are not fiduciaries is “suitability” - a lower standard
- An adviser may be a fiduciary in some instances and not a fiduciary in others (hat switching)

Ways to Address "Hat Switching"

- Advisers Act: SEC considering elimination of the exception for broker-dealers

- ERISA: The Department of Labor proposed a rule that would have defined most advisers to be fiduciaries if they receive compensation for advice regarding plan assets
  - Proposed rule withdrawn; expected to be re-proposed

Conclusions

- Advisers provide a valuable service to people who are not financially sophisticated.
- They work for a variety of different employers, can have different educational backgrounds and different certifications.
- Due to the way they are compensated, they can be subject to conflicts of interest.
- Regulation is being considered to address the “hat-switching” problem.