

# The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice

Guest Presenters:

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# Motivation



- **Early version of Dodd-Frank would have eliminated B/D exception under Investment Advisers Act**
- **SEC study recommends adoption of uniform fiduciary standard for broker-dealers and investment advisers**
- **Chairman Schapiro calls for “additional relevant data or empirical analysis” prior to regulatory action**

# Overview



- **Consumers unable to differentiate between broker-dealers and investment advisers**
  - Hung et al. (2008)
- **Informational imbalance in any professional advice profession**
- **Creates opportunity for self-serving behavior**

# Overview of Agency Theory



- Principal (household) hires agent (adviser) to provide expert information, improve welfare
- Agency always involves costs since principal and agent motivated by self-interest
  - Jensen and Meckling (2006)
- Principal relies on expert if costs < expected benefits

# Problems with Advice Market



- Very difficult for consumer to assess quality of advice
- Most consumers assume adviser is a fiduciary
  - Hung et al. (2008)
- Lack of uniform standards increases confusion about how much monitoring is needed

# Fiduciary and Suitability



- Under suitability standard, adviser objective is to maximize its welfare subject to suitability constraints
  - Cummings and Finke (2010)
- Reputational motivation weak if quality difficult to perceive
- Provides opportunities to extract wealth from clients

# Possible Problems with Fiduciary Standard



- **May limit products adviser can recommend**
  - (Headley, 2011)
- **May discourage brokers from providing services**
  - (Headley, 2011)
- **Questions about whether fiduciary standard consistent with commissions**
- **Commission compensation provides greater incentive to advise moderate wealth clients**
  - Dean and Finke (2011)



# State Broker-Dealer Common Law Standards



- Some states apply fiduciary duty to broker conduct
- **Missouri:**
  - “stockbrokers owe customers a fiduciary duty.”
    - ✦ Paine Webber v. Voorhees, 1995)
- **California:**
  - ✦ Hobbs v. Bateman Eichler, Hill Richards, Inc., 1985)
- **South Dakota:**
  - ✦ Dismore v. Piper Jaffray, Inc., 1999)
- **South Carolina:**
  - ✦ Cowburn v. Leventis, 2005)

# No Fiduciary Standard



- Arizona, Arkansas, Colorado, Hawaii, Massachusetts, Minnesota, Mississippi, Montana, New York, North Carolina, North Dakota, Oregon, Washington, and Wisconsin

# Quasi-Fiduciary Standards



- Impose standards that exceed the suitability standard set forth under FINRA rules (for non-discretionary accounts), but do not expressly classify broker-dealers as fiduciaries:
  - Alabama, Alaska, Connecticut, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Michigan, Nebraska, New Hampshire, New Jersey, New Mexico, Nevada, Ohio, Oklahoma, Pennsylvania, Rhode Island, Tennessee, Texas, Utah, Vermont, Virginia, West Virginia, and Wyoming

# Empirical Analysis



- 1) Compare frequency of registered representatives (saturation) in states applying fiduciary, quasi-fiduciary, non-fiduciary standards
- 2) Survey registered representatives in fiduciary and non-fiduciary states to estimate differences in ability to conduct business

# Research Questions



- Do fiduciary standards impact how broker-dealers conduct business
- A) Reduce number of registered representatives
- B) Reduce ability to recommend range of products
- C) Reduce ability to serve lower-wealth clients
- D) Reduce ability to recommend commission products

# Data & Methods



- **Broker-Dealer Survey**
  - Random sample of registered representatives in non-fiduciary and fiduciary standard states between November 28 and December 23, 2011
    - ✦ 207 valid responses
    - ✦ Frequency comparison test (chi-squared)
  
- **Saturation Analysis**
  - Population of registered representatives active in November 2011 with either a Series 6 or 7
    - ✦ 516,168, 51 states and DC
    - ✦ Multivariate Analysis using income (log) as control

# Survey Results:

## Serve lower wealth/income clients?



Question	Fiduciary States	Non-Fiduciary States	Difference (Fiduciary – NF)	P-Value Equal
% clients income < \$75,000	28.0%	27.9%	0.1%	0.982
% clients inv assets > \$750,000	29.5%	34.5%	-5.0%	0.261
Serve needs of low/mod wealth	78.9%	79.8%	-0.9%	0.878
Less affluent avoid due to cost	23.6%	29.2%	-5.6%	0.374

# Survey Results: Recommend Variety of Products?



Question	Fiduciary States	Non-Fiduciary States	Difference (Fiduciary – NF)	P-Value Equal
Regulation limits product range	21.3%	17.4%	3.9%	0.486
Products meet client needs	95.8%	97.3%	-1.5%	0.561
Advice tailored to client needs	91.7%	90.1%	1.6%	0.695



# Survey Results: Affects Ability to Conduct Business?



<b>Question</b>	<b>Fiduciary States</b>	<b>Non-Fiduciary States</b>	<b>Difference (Fiduciary – NF)</b>	<b>P-Value Equal</b>
Able to recommend commission	88.5%	88.2%	0.3%	0.936
Cost of compliance significant	70.9%	61.9%	9.0%	0.190
Act in best interest of client	97.8%	96.3%	1.5%	0.526

# Broker Saturation Rates



	<b>Registered Representatives</b>	<b>Households (000s)</b>	<b>Saturation</b>
Total Fiduciary	69,120	16,817	3.96
Total Non-Fiduciary	186,802	29,504	6.33
Non-Fiduciary W/O New York	89,940	22,279	4.04
Total Other States	260,246	68,278	3.81

# Non-Fiduciary Saturation and New York



Non-Fiduciary States			
<b>New York</b>	<b>96,862</b>	<b>7,221</b>	<b>13.41</b>
North Carolina	15,094	3,666	4.12
Washington	6,605	2,601	2.54
Massachusetts	16,207	2,521	6.43
Arizona	7,280	2,333	3.12
Wisconsin	10,164	2,282	4.45
Minnesota	8,644	2,093	4.13
Colorado	14,168	1,942	7.30
Oregon	5,291	1,506	3.51
Arkansas	1,787	1,120	1.60
Mississippi	1,728	1,085	1.59
Hawaii	974	443	2.19
Montana	949	404	2.35
North Dakota	1,049	278	3.77

# Comparison of 2-3 million household states



	<b>State Regulation</b>	<b>Reps/Hhlds</b>	<b>Median Income</b>	<b>Mean Income</b>	<b>% High Income</b>	<b>% College Education</b>
<b>Missouri</b>	<b>Fiduciary</b>	<b>2.65</b>	<b>45,829</b>	<b>60,760</b>	<b>5.36</b>	<b>25.31</b>
Washington	Non-Fid.	2.54	56,911	73,854	8.99	31.02
Massachusetts	Non-Fid.	6.43	63,961	85,865	13.52	38.54
<b>Arizona</b>	<b>Non-Fid.</b>	<b>3.12</b>	<b>49,214</b>	<b>65,552</b>	<b>6.68</b>	<b>26.12</b>
Wisconsin	Non-Fid.	4.45	50,814	64,463	5.55	25.88
Minnesota	Non-Fid.	4.13	56,456	72,850	8.35	31.59
Virginia	Other	2.62	61,090	82,369	12.83	33.92
<b>Indiana</b>	<b>Other</b>	<b>3.37</b>	<b>46,529</b>	<b>60,275</b>	<b>4.90</b>	<b>22.70</b>
<b>Tennessee</b>	<b>Other</b>	<b>2.66</b>	<b>42,612</b>	<b>58,360</b>	<b>5.37</b>	<b>22.92</b>
Maryland	Other	4.61	70,017	90,800	15.18	35.58

# Regression Results



Variable	Coefficient	P-Value
Fiduciary	-0.488	0.601
Non-Fiduciary	0.759	0.180
Log Income	8.941	0.000
Adj. R-Square	0.39	

# Regression Results with New York Effect



Variable	Coefficient	P-Value
Fiduciary	-0.542	0.447
Non-Fiduciary	-0.154	0.726
Log Income	7.741	0.000
New York	8.290	0.000
Adj. R-Square	0.65	

# Conclusions



- **No statistical evidence of difference in:**
  - Ability to service lower-wealth/income customers
  - Ability to provide variety of products
  - Ability to conduct business
- **No significant difference in saturation rates when income controlled**
  - New York saturation inflation = 8.3
- **Empirical evidence suggests fiduciary standards have little impact on Broker-Dealers**

# Thank you!



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*Access the full study at:*

[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2019090](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2019090)

## Additional announcements

- The 2012 fi360 Conference is just 5 weeks away! Join us in Chicago April 25 - 27 and gain valuable insights from leading fiduciary experts, discuss the industry's hottest topics, and share your professional experiences with colleagues. Also be sure to check out our convenient pre-conference AIF®, AIFA® and fi360 Toolkit training events taking place April 23 – 25. ([http://www.fi360.com/main/conference\\_2012.jsp](http://www.fi360.com/main/conference_2012.jsp))
- If you are currently an fi360 Member, be sure to take a look at the series of new marketing brochures that are now available. Customized to target a specific client type, each piece has been carefully crafted to position YOU as an expert in fiduciary services. Login to the Designee or Toolkit Portal for more information.

# Thank you

- Continuing education for the AIF and AIFA designations will be reported by fi360
- Visit the fi360 Blog for a follow-up post to answer your questions: <http://blog.fi360.com>
- A recording of this webinar will be available soon in the archive ([www.fi360.com/webinars](http://www.fi360.com/webinars)) and in the Designee Portal
- Email [resources@fi360.com](mailto:resources@fi360.com) with any additional questions or comments