HAWAII WEALTH MANAGEMENT

Who's the Fairest of Them All? - A Comparative Analysis of Financial Advisor Compensation Models

January 2006

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Research Topic: Professional Issues – Ethics of Financial Advisor Compensation

Paper Title: ***Who's the Fairest of Them All? - A Comparative Analysis of Financial Advisor Compensation Models***

Executive Summary:

There are three primary modes by which investors pay for professional investment and financial planning guidance – commissions, asset fees, and flat/hourly fees. This paper examines the economic incentives at work in all three in an effort to determine which is the "fairest" for investors. The following key points arise from this analysis and are intended to spur debate over the ethics of current financial advisor compensation practices:

- The debate over which model is best is fundamentally flawed, since (1) all three models contain incentives that can lead to conflicts of interest, and (2) each of the three models represents an optimal choice for certain investor circumstances.

- The recent trend away from commissions in favor of fee-only planning may not represent a "best practice" model for the profession. Alternatively, it can be argued that the ideal compensation platform should incorporate all three models.

- The Utopian ideal of providing a truly fair and objective compensation platform cannot be achieved until informational asymmetries regarding fees and commissions between advisor and investor are eliminated, fiduciary standards are applied to advisors across all three models, and regulatory enforcement continues its increasing rate of effectiveness at deterring unethical advisor behavior.

"Incentives are the cornerstone of modern life. And understanding them – or, often, ferreting them out – is the key to solving just about any riddle, from violent crime to sports cheating to online dating." - ***Freakonomics*** by Steven D. Leavitt and Stephen J. Dubner

INTRODUCTION

Retail investors obtain personalized financial guidance from a variety of sources including national and regional brokerage firms, registered investment advisory firms, and independent financial planners. Depending upon the source that is chosen, there are essentially three manners in which investors pay for financial guidance – commissions, asset-based fees, and flat/hourly fees. Over the past decade or so, as the investment industry has evolved from its sales-oriented origins towards a financial planning orientation, the traditional commission model has come under increasing fire for the seemingly obvious conflict of interest that commission-based sales create between the financial advisor[i] and the investor. As a result of this criticism, there has been a paradigm shift away from transactional compensation towards asset fees, and, to a lesser extent, towards flat/hourly fee planning – the rationale being that fee-based compensation better aligns adviser and investor interests. In fact, some advisers have adopted an almost moralistic position in advocating the exclusive use of either of the fee-based models. So vocal has been the "fee-only" movement that there has been very little formal discussion of limitations associated with either of the fee-based models or comparative analyses of the merits or disadvantages of all three models relative to each other.

But are the two fee-based models always better for the investor? This paper addresses this question by ferreting out and examining underlying economic incentives at work in all three models and by identifying those incentives which may create advisor/investor conflicts. The analysis concludes that all three models contain incentives which both align advisor and client objectives and which can create significant conflicts of interest. This somewhat controversial finding has at least three important implications – (1) no single compensation model assures investors that the advice they receive will be entirely unbiased and objective; (2) since all three models have limitations, the financial planning community should think carefully about promoting fee-only planning as a "best practices" model for the profession; and (3) since each model may also be an optimal choice for certain sets of investor circumstances, the "fairest" compensation platform may be one which offers investors the ability to choose from all three models.

In addition to the inherent structural economic incentives in each compensation model, regulation represents a powerful external influence on financial advisor behavior. Presumably, the purpose of regulation is to protect investors by imposing external incentives (through rulemaking and enforcement) that will help advisor and client interests become more aligned and/ or that will effectively deter unethical advisor behavior. This comparative analysis considers the influence of regulation on advisor incentives and concludes that in the absence of significant reform, universal adoption of the three-model platform would do little to ensure that the manner in which financial advisors are compensated for their guidance and service is uniformly fair and ethical. In particular, the analysis finds that improved disclosure of fees and commissions is needed to eliminate undesirable incentives that currently arise from informational asymmetries in the commission model, and that greater policing and enforcement is needed to curb unethical behavior such as "double-dipping" among investment advisers.

THE COMMISSION-BASED COMPENSATION MODEL

Despite the widespread migration toward fee-based compensation models, commission-based guidance is still provided by thousands of financial advisors at hundreds of broker-dealers nationwide.[ii] Commission-based advisors are regulated by the SEC under the Securities Exchange Act of 1934 and by various self-regulatory agencies, most notably the FINRA. As referenced above, the primary criticism of the commission model stems from the obvious problem that the advisor's economic incentives appear to be, at best, detached from the interests of the investor, or, at worst, in direct conflict with the investor. Under this model, the advisor's interests seem detached from the investors because he receives a commission regardless of whether the investments recommended succeed or fail. Further, it can argued that the commission model creates an economic incentive for the advisor to steer investors toward products that pay the highest commissions, even if those products are not necessarily best suited for the investor. As such, detractors of the commission model suggest that the quality of financial guidance dispensed from commission-based advisors should be viewed with skepticism and should be discounted relative to that of fee-based advisors.

As straightforward and as convincing as these criticisms of the commission model may seem, an objective comparison of the three models requires us to look beyond the obvious and to consider whether there are any underlying incentives or circumstances which might actually make the commission-based model a better choice for certain investors than the fee-based models. Specifically, we are compelled to ask whether the conflict of interest argument accurately reflects the behavior of financial advisors. Most commission-based advisors contend that it does not and that, in reality, their interests are far more aligned with investors than one might think. From the commission-based advisor's perspective, the financial services industry is a crowded and competitive place, and attracting new clients is more difficult than ever. If one accepts the assumption that investors will eventually leave advisors who abuse their trust, then commission-based advisors may indeed have an incentive to forgo short term gratification from commission-maximization in order to keep investors happy over the long run so that they will (1) continue to generate revenue, and (2) refer other investors. Similarly, commission-based advisors could also argue that they do not have an incentive to steer clients disproportionately toward investments with high upfront commissions because such investments tend to be "one-shot deals" (i.e., the advisor may not get paid again). Allocating client assets entirely toward these products would mean that the advisor must constantly be prospecting for new investors.

Interestingly, there is ample evidence to support the commission-based advisor's position, and to suggest that the conflict of interest criticism surrounding the commission model may be overly simplistic. If commission-based advisors truly have a greater economic incentive to put their interests ahead of investors, then one would expect commission-based advisors to have higher returns on assets (ROA) than their fee-based counterparts. In fact, the opposite is true, and by a rather wide margin. Industry data regularly report that the average return on assets (ROA) for registered reps is below .75%, while the average ROA for independent RIAs is approximately 1.3% and rising[iii]. Not only does this suggest that commission-based advisors as a group are not solely motivated to maximize commissions, it implies that the commission-based model may have a significant cost advantage over fee-based investing.

In addition to the debate over the structural legitimacy of the commission-based model relative to the fee-based models, regulatory disparities between the two camps are also a source of contention. Specifically, fee-based model advocates maintain that it is unfair and misleading to investors that commission-based advisors are allowed to present themselves as purveyors of financial guidance while being held to a much lower standard of accountability than the fiduciary standards to which asset fee and flat/hourly advisers are held. Under the Securities Exchange Act of 1934 investment recommendations by commission based advisors are only required to be “suitable” for investors, whereas the fiduciary standards under the Investment Advisers Act of 1940 require investment advisers to always place the interests of their clients above their own and hold the adviser personally liable for breaches of fiduciary duties.

Although this important distinction does seem to lend support to advocates of the fee-based models, commission-based advisors counter that the distinction between the “suitability” standard and the “fiduciary” standard is not as great as critics suggest, and that strict regulation and the credible threat of enforcement provide powerful incentives to act in their clients’ interests. They note that the FINRA has strict rules to protect investors from individual “rogue brokers” and that broker-dealers are required to closely supervise client accounts to prevent abuses from churning or inappropriate investment recommendations. For example, the FINRA requires broker-dealers to closely scrutinize the practices of financial advisors with unusually high commissions relative to assets (typically ROAs above 2.0%), client accounts with significant losses, and/or high portfolio turnover ratios. More recently, the FINRA and SEC have also intensified scrutiny of 1035 exchanges of annuities and life insurance products, increased regulation of commission-based mutual fund sales, and imposed new rules governing the distribution of equity syndicate offerings. Additionally, in an April 19, 2005 release, the SEC issued a new rule aimed at clarifying the differences between commission and fee-based advisors. In the text of this rule the Commission affirmed commission-based advisors’ roles as a source of financial guidance, but ruled that they may not represent their services to the public as “financial planning” unless the advisor is also registered as an investment adviser.[iv]

Another important and contentious regulatory issue stems from the fact that the Investment Advisers Act mandates that fee-based advisers clearly disclose all fees and expenses to investors. Fee-based model advocates contend that no analogous standard exists for commission-based advisors. Indeed, it is true that the mark-ups on bonds, dealer concessions on syndicate products, and commissions paid on annuities and life insurance products are largely opaque to investors. This informational asymmetry clearly provides the opportunity for advisors to put their interests in commissions ahead of investors. Evidence of the inadequacy of disclosure regulation under the 1934 Act abounds. For example, a full page advertisement for a particular annuity contract in the November 2005 issue of the Journal of Financial Planning touts an 10% commission as a primary benefit of the product. Although the April 15, 2005 SEC release also requires non-advisory broker-dealers to issue written disclosure to investors stating that “Our interests may not be the same as yours”, this mandate falls far short of transparency.

To summarize, an analysis of the economic incentives at work in the commission model suggest that a rational defense of this form of compensation is plausible and that the main conflict of interests argument may not be as compelling as the model’s detractors suggest. In fact, the ROA data suggest that lower cost may be a compelling reason for some investors to consider adopting the commission-based model. Intuitively, such a model would seem to be a rational economic choice for “buy and hold” equity or mutual fund investors, or for investors with static or laddered fixed income portfolios or large cash positions. Recent regulatory concerns over the issue of “reverse-churning”[v] lend further credence to the potential advantage of commissions over asset fees for relatively inactive portfolios. Ironically, a review of externally imposed incentives finds that inadequate and unbalanced regulation, rather than inherent structural conflicts of interest, looms as the biggest reason to question the legitimacy and fairness of the commission model. Clearly, the legitimacy of the commission model is being artificially impaired by a lack of transparency and by a lower regulatory accountability standard. Although many fee-only advocates point to the differences in regulatory standards as a reason to shun commission-based guidance, it is interesting to note that many commission-based advisors – particularly those who hold professional certifications such as the CFP® and CFA marks - feel that the regulatory imbalance unfairly degrades the credibility of their guidance and openly favor a rule change that would raise their level of accountability to match the fiduciary standard of the Investment Advisers Act of 1940.

THE ASSET FEE MODEL

As referenced above, advisers who are compensated for financial planning and investment advice via asset-based fees must be registered as Investment Advisers under the Investment Advisers Act of 1940. Financial professionals who wish to be compensated in this manner must hold the FINRA Series 65 or 66 registration and their firms, depending upon the total amount of client assets under management, must be registered either with the SEC (RIAs with greater than $25 million in client assets) or with their states’ Securities Commissioners. Although most national and regional investment firms carry dual broker-dealer and RIA registrations, the strongest growth in the RIA arena in recent years has come from “fee only” RIAs which operate independently from any broker-dealer.

The most vociferously touted benefit of the asset fee compensation model is that it aligns the adviser’s economic incentives with the interests of the investor. Specifically, under the asset fee model, the adviser is paid more if the portfolio value rises and less if the value falls. Additionally, in accordance with the Investment Advisors Act of 1940, advisory fees must be clearly disclosed to investors. As discussed, this transparency is a clear advantage over the commission-based world, as is the fiduciary responsibility to place the investor’s interests above the adviser’s own.[vi] In economic terms, all of these factors combined seem to provide a strong incentive for advisers to be ethical and diligent in their recommendations, and they undoubtedly explain a large part of the exponential growth in both the number of independent RIAs and the amount of money invested in investment advisory accounts in recent years.

But are there disadvantages and/or conflicts of interests with the asset fee model too? Cost relative to the commission model is one previously mentioned potential disadvantage, but are there others? Again, the place to start is by taking a more detailed review of the model’s incentive structure. At first blush, it seems intuitive that adviser-client interests are always aligned under the asset fee model; however, there are at least two scenarios where adviser guidance under this model may be directly at odds with the interests of the client. First, since the asset-fee adviser is paid based on a percentage of assets under-management, it can be argued that there is a strong disincentive to provide investment solutions that do not involve adviser management or which might reduce the amount of investor assets under management. For example, the adviser might be disinclined to advise investors to reduce debt or invest in assets such as real estate or art.[vii] Similarly, an asset fee adviser might also be reluctant to recommend holding cash or static/laddered bond portfolios outside of the fee arrangement, even if it is in the investors' interests to do so. Second, since most asset fee advisers adamantly eschew commissions, it is reasonable to expect there to be a strong disinclination to recommend certain products such as life insurance, long term care insurance, or certain annuity contracts which are only available on a commission basis, even if these products may be appropriate for the investors. Neither of these scenarios would likely be considered a breach of fiduciary duty, but the advisers' economic incentives in both examples are indisputably disengaged from those of the investors.

Further, while regulatory disclosure and accountability standards lend considerable credence to the merits of fee-based investing, it is also reasonable to ask whether these high standards are effective in deterring unethical behavior. Although this notion is accepted as given among RIA proponents, circumstantial evidence suggests that the fiduciary liability threat may not be as effective a deterrent as one might think. Examples of fee-only advisers who receive undisclosed "on-the-side" commissions from the sales of certain insurance products are commonplace. More concrete evidence of "double-dipping" is provided in a recent survey by consulting firm Tiburon Strategic Advisors which found that a disturbing 15% of investments managed by fee-only advisers are in commissionable investments.[viii] The study also found that a surprising 52% of independent RIAs maintained FINRA Series 7 General Securities registrations. Thus, while the fiduciary standard provided under the Investment Advisers Act of 1940 does assign personal liability to advisers for their recommendations, the deterrent effect of the regulation is questionable. One possible reason may be a lack of enforcement brought about by the sheer number of RIAs to police. According to Tiburon there are approximately 19,500 fee-only RIAs in the U.S. Of these, state-regulated RIAs with fewer than $25 million in investor assets represent 61% of the total, while SEC-regulated RIAs comprise the other 39%. Evidence of the difficulty of enforcement can be found from the SEC's 2005 Investment Adviser Registration Depository, which indicated that a full 54.6% of SEC RIA firms failed to even name a chief compliance officer as required on their Form ADV[ix].

From the investor's perspective, the notion that both the adviser and client benefit when asset values rise and suffer when assets fall is indeed a desirable attribute and is a distinct advantage of the asset fee model for certain investor circumstances. Intuitively, the model seems particularly well suited for long-term growth oriented investors who prefer a hands-off approach to investing (i.e., adviser discretion). Greater expense transparency is also a clear advantage of the asset fee model over the commission model. However, this analysis has shown that, as with the commission model, the asset-fee model inherently contains significant structural incentives that can lead to direct conflicts of interest between adviser and investor. Further, despite higher regulatory standards of accountability, investors who employ asset-fee advisers are by no means immune to deceptive sales practices by unscrupulous advisers who breach their fiduciary duties by profiting from both asset fees and undisclosed sales commissions.

THE FLAT RATE/HOURLY FEE COMPENSATION MODEL

Conflicts of interest in both the commission-based and fee-based compensation models and a desire to provide complete objectivity have motivated a growing number of advisers to provide financial planning guidance on a flat fee basis. Since flat fee practitioners are not engaged in the purchase or sale of securities, securities registrations are not required. However, as long as such practitioners are engaged in the business of giving financial planning advice and are providing advice to five or more clients, they are required to register under and are regulated by the Investment Advisers Act of 1940. Some planners charge a flat fee for a one time up-front financial plan or portfolio review, while others charge strictly on an hourly basis. Still others combine these two approaches by charging a one-time up front fee for developing a plan and an hourly rate thereafter. Another variation of this model incorporates annual or quarterly retainers. According to the IAA/NRS 2005 joint report on the status of the investment adviser profession entitled "Evolution Revolution", 42% of independent RIAs charge hourly fees and 34% charge flat fees.

On the surface, this compensation model appears to offer investors a significant benefit by avoiding the notable conflicts of interest in both the commission and asset fee models. Under flat rate/hourly model the planner appears to have no incentive to recommend any investment or strategy that is not in the best interests of the client. Since the flat/hourly fee planner is not engaged in the purchase or sale of securities, no conflicts of interest should arise from product recommendations either. Similarly, since the flat/hourly fee adviser is not compensated on assets under management, he or she may be more inclined to consider recommending strategies such as debt reduction or investments in real estate. Fee transparency is also obviously a non-issue with the flat rate/fee only model.

However, to fully evaluate the merits of this model relative to the other two, again requires considering the possibility that an entirely different set of incentives exist in the flat/hourly fee model which may place the adviser's interests in conflict with the investor's. In approaching the flat/hourly fee model from the perspective of the adviser's economic incentives, several potential problems become readily apparent. First, cost may present a disadvantage in some common client circumstances. This stems from the fact that some investors may essentially end up paying twice for guidance – once for the planner's guidance and again to purchase the investments or strategies that the planner recommended. In defense, some flat/hourly fee advisers may contend that they steer clients toward low cost index based investments and that greater objectivity may be worth any additional expense. However, it can be countered that artificially restricting product breadth to minimize product acquisition expenses may be penny-wise and pound-foolish. This leads to a second structural flaw in the model. As with the asset fee model, it can be argued that the flat/hourly fee structure creates an incentive for the adviser to avoid certain commission-based products, such as certain annuities and life insurance products that may be appropriate for some investors. Conversely, as with the asset fee model, investors who employ flat/hourly fee advisers may also be vulnerable to "double-dipping" schemes of unethical advisers who fly under the radar of state securities regulators.

Another potential economic limitation that is unique to the flat/hourly fee model may be loosely referred to as "shirking". Unlike the asset-fee model, the flat/hourly fee adviser's compensation is not tied to performance. As such, the flat/hourly fee adviser may have a proclivity to gravitate toward investment planning strategies whose performance is more difficult to measure (e.g., real estate, private equity, debt reduction, etc.). In addition, the flat/hourly fee adviser has an incentive to charge the most for his or her services for the least amount of work. For example, flat fee advisers who are compensated via a flat up-front payment or by a quarterly retainer may have an incentive to provide boiler plate guidance to all clients, since it will result in higher dollar per hour compensation than customized guidance. Similarly, flat fee advisers who charge on an hourly basis may have an incentive to either "pad" their bills or to adopt the concept of "value billing". This is a relatively common issue of ethical contention among attorneys, and it seems natural that such practices should arise with flat/hourly fee planners as well.

In sum, one can certainly contend that the flat/hourly fee model is the most objective of the three models for investors who might benefit from non-securities based planning strategies such as debt reduction and investment in real property. The flat/hourly fee model would also seem to be an ideal choice for investors seeking a third-party assessment of an existing investment strategy or financial plan, or for investors who prefer to have the opportunity to consider the quality of the adviser's guidance before committing assets to the plan. For other investors, the flat fee model has many of the same potential limitations relative to the commission model as the asset fee model - (1) It may be more expensive than the commission model for certain buy and hold investors; (2) flat/hourly fee planners may be reluctant to consider certain commission-based investments regardless of suitability; and (3) lax regulatory enforcement may leave investors vulnerable to "double dipping" by unscrupulous advisers. Relative to the asset fee model, it can be argued that the flat/hourly fee adviser's interests are not as closely aligned with the investors since his or her success is not tied to the value of the portfolio.

CONCLUSION - IMPLICATIONS OF THIS ANALYSIS

To borrow a quotation from the best selling book *Freakanomics* by Steven D. Levitt and Stephen J. Dubner, "Morality, it could be argued, represents the way that people would like the world to work – whereas economics represents how it actually does work." Over the past decade or so there has been a paradigm shift away from commission-based financial guidance to fee-based planning. This shift has been largely predicated on the perception in the financial planning community, academia, and the media that fee-based planning is morally superior to commission-based guidance. According to this conventional wisdom, those who have migrated to the fee-only model represent the enlightenment, while advisors who remain commission-based are marginalized as self-serving troglodytes who are destined to soon go the way of the Neanderthal. The purpose of this analysis has been to assess the validity of this perception by examining each of the three advisor compensation models from an economic perspective instead of a moral one. More specifically, this analysis has sought to identify underlying structural and regulatory imposed economic incentives in each model in an attempt to determine which of the three models is indeed the "fairest" for investors.

Although this analysis does not claim to have exhaustively identified all of the economic forces that may be at work in each model, it has identified incentives in all three models that both align advisor and investor interests and create conflicts between them. As such, a comparison of the three models suggests that each model may be the "fairest" choice under certain common sets of investor circumstances, and that no single model can be deemed to be completely fair or without bias for all investors. Importantly, this suggests that the growing trend toward espousing the moral superiority of a single compensation model may not be a best practice for the profession. While it may be possible to forge a debate over which compensation model represents the fairest choice for the broadest segment of the investing population, the problem with traveling down this path is that it incorrectly assumes that advisors are limited to offering investors just one way to pay for their services. In fact, financial advisors who hold dual investment adviser and broker registrations may be free to offer all three compensation options. Since each model may be the optimal choice for certain investors' circumstances, it seems logical that the ideal compensation structure for the investor is one which offers a choice or combination of all three models. As an example, one can envision a scenario in which a prospective client elects to pay an hourly fee or flat fee for an initial comprehensive financial planning analysis with the opportunity to have the fee waived if he elects to implement the plan through the adviser. Further, the investor might also elect to have the cash and fixed income portion of the portfolio managed under a transaction-based compensation model, while the long term growth portion might be subject to a fee on assets.

Despite the recent growth in the number of independent RIAs and abundant rhetoric espousing the moral superiority of fee-only planning, industry statistics provide strong evidence that there is an underlying groundswell of acceptance of the three-model platform. For instance, results of a 2005 survey conducted by the College for Financial Planning in conjunction with the Financial Planning Association revealed that 56% of CFP® professionals report receiving income from a combination of fees for service and commissions, while just 34% reported that their incomes are from fee-only services[x]. Interestingly, these statistics also seem to suggest that purveyors of commission-based guidance are no less qualified or competent than their fee only peers, since a majority of CFP®s hold dual advisory and broker registrations. Also lending support to the wide-spread adoption of the three-model platform is the fact that virtually all of the major national and regional investment firms have adopted it in some form and that the vast majority of advisors at these firms hold dual registrations. Additionally, as referenced earlier, even among the ranks of smaller independent RIAs, more than half (52%) have maintained their brokerage registrations.

While our quest to answer the riddle of which advisor compensation model is the fairest of them all has led us to conclude that the ideal platform should incorporate all three models, it is important to note that, even if all financial advisors were to adopt this approach tomorrow, advisor compensation would still be a far cry from Utopian. While the three model platform does much to address and eliminate the structural conflicts of interests that are inherent in each model, merely making the three model platform the universal standard would likely do little to bring us closer to the Utopian ideal. Ironically, the most significant barrier to achieving a universally fair and objective adviser compensation system is regulation. In particular, inadequate disclosure requirements, unbalanced accountability standards, and lax regulatory enforcement imbalances stand out as problems in the current environment.

With respect to disclosure, as long as informational asymmetries are allowed to exist between advisors and investors, investors may be vulnerable to manipulation and therefore hindered from selecting the most appropriate compensation model. While the Investment Advisers Act of 1940 requires investment advisers to clearly disclose all fees, disclosure requirements on the broker-dealer side of the fence are far from transparent. Mark-ups on bonds, dealer concessions on syndicate items, life insurance and annuity commissions, and mutual fund sales charges and fees are frequently poorly disclosed and largely opaque to the average investor. The obvious solution would be to require commission-based advisors to disclose in writing the commission that is paid on each transaction. Such a proposal would undoubtedly be met with a firestorm of opposition, but if the goal is to design a compensation model that is truly fair, investors should have the right to assess the degree to which their advisor's recommendations may be influenced by the commissions he is slated to receive. In the absence of full disclosure, the potential for conflicts of interest will always exist.

Additionally, the different accountability standards for brokers versus investment advisers have created artificial problems for the three model platform. Specifically, the fiduciary standard difference (along with the fee disclosure differences) artificially disparages the credibility of the commission model relative to the fee-based models. However, given that investment advisers are not necessarily more qualified or experienced and that an enormous number of advisors hold dual registrations, it makes little sense for different standards to exist.

Finally, in order for advisor compensation to come closer to the ideal, regulation must be perceived by investors as an effective deterrent to unethical behavior. In the aftermath of the slew of scandals that the plagued the brokerage industry at the start of this decade, it can be argued that regulation and enforcement by the SEC and the FINRA have been dramatically stepped up for commission-based advisors. However, although the disclosure and accountability standards under the Investment Advisers Act of 1940 are unquestionably superior, inadequate monitoring and enforcement may be leading some advisers to conclude that the risks and penalties of being caught "double dipping" or selling away are worth taking.

Thus, while we conclude that the three model platform seems to represent the fairest compensation system for investors, until full disclosure of fees and commissions is required for all products and services, until all advisors are held to fiduciary accountability standards, and until the threat of regulatory enforcement action becomes an effective deterrent against unethical behavior, the notion of an advisor compensation system that is truly fair to investors will remain a mythical ideal. Although this and other conclusions presented herein may be regarded as controversial, they are intended to spark a healthy debate about the ethics of advisor compensation and the future direction

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[i] Throughout this paper, "advisor" is used when referring specifically to commission-based professionals and when referring generically to all investment professionals (i.e., including both investment advisers and registered representatives). "Adviser" is used when specifically referring to registered investment advisers.

[ii] Although broker-dealers are currently permitted to offer fee-based compensation programs that are exempt from the Investment Advisers Act of 1940, the debate over the legitimacy of this practice is regarded as a separate issue and, as such, discussion of this topic has intentionally been omitted.

[iii] Source: Investment Adviser Association/National Regulatory Services 2005 joint report on the state of the investment adviser profession entitled "Evolution Revolution". Note: This data applies to asset-based fees only. The author does not have ROA statistics for flat/hourly fee advisors.

[iv] Source: SEC Release Nos. 34-51523; IA-2376; File No. S7-25-99, *Certain Broker-Dealers Deemed not to be Investment Advisers; Final Rule*, April 19, 2005.

[v] Reverse churning refers to regulatory concerns over the practice of charging asset-based fees on portfolios that require little or no active management. To date, the focus of reverse churning investigations have been non-advisory fee-based brokerage accounts. However, the question could also be posed as to whether

investment advisers are truly placing the interests of their clients first by levying fees on certain types of assets.

[vi] Non-advisory wrap fee brokerage accounts are excluded from this requirement. It should be noted that this discussion of the advantages and disadvantages of the asset-based fee model is intentionally limited to true investment advisory accounts.

[vii] Note the same point could be raised with the commission model, however, perhaps less so, since the commission advisor might benefit from a sales transaction and he or she does not benefit from assets under management.

[viii] It is unclear whether the 15% figure incorporates sales of commission-based life insurance products. If not, this may be further evidence of even greater ethical lapses within the fee-only adviser community.

[ix] Source: IAA/NRS 2005 joint report entitled “Evolution Revolution”.

[x] Source: 2005 Survey of Trends in the Financial Planning Industry.