

Compensation and client wealth among U.S. investment advisors

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Abstract

This study uses disclosure data from 7,043 Registered Investment Advisors (RIAs) in the United States to examine differences in client wealth by type of compensation. Results suggest that firms charging commissions and hourly fees have a higher proportion of low net worth clients. Wealthier clients are more likely to be charged performance-based fees and fees based on assets under management. RIA firms that charge commissions are more likely to provide financial planning services in addition to investment advice. Results suggest that policy restricting compensation may impact the provision of advising services to average investors. © 2012 Academy of Financial Services. All rights reserved.

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1. Introduction

The global financial crisis has spurred governments to take a closer look at financial service policy and the regulation of investment advisors (Inderst, 2009). Recently, the Financial Services Authority (FSA) in the United Kingdom banned financial advisors from receiving commissions on retail investment products and volume-based sales beginning in 2013 (FSA, 2010). This was done in an effort to tie charges to “the level of service provided”

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to the consumer as opposed to the “particular provider or product” being recommended by the financial advisor (FSA, 2010). Australia enacted similar legislation that will take effect in July 2012. The United States took an entirely different approach to the issue of consumer protection and enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act, which gave the Securities and Exchange Commission (SEC) explicit authority to impose a fiduciary duty on all investment advisors and brokers (U.S. Senate Committee on Banking, Housing, and Urban Affairs, 2010).

Opponents of legislation to limit commissions argue that restricting compensation will reduce the amount of financial service professionals in the industry. Because commissions provide greater compensation per initial dollar invested, it is possible that advisors will not cater to low or moderate net worth households. Small investors may also be less willing to seek out and pay for professional advice if its cost is more readily apparent because commission expenses are more opaque than other advising fees.

The purpose of this study is to empirically test whether there is an association between client wealth and investment advisor compensation. Using data from required SEC disclosure from the population of United States investment advisors with at least \$25 million in assets, we find that commission and hourly fee compensation is associated with advisors who cater to lower net worth clients. Advisors who cater to higher wealth clients are more likely to charge performance-based fees. Of most importance to policy, our findings suggest that commission compensation is most common among advisors who provide financial planning services, have more employees, and cater to lower-wealth clients.

2. Investment advisor compensation

Commissions and asset fees each involve potential costs and benefits to consumers and firms. Commission compensation provides a strong sales incentive and while this provides operational benefits to the firm (Nisar, 2007), it may emphasize product over advice (Gravelle, 1994). Tying employee compensation to product sales creates an incentive to recommend inferior products that provide a more generous commission (Mantel, 2005). Firms may favor commissions to improve sales force productivity (Holmstrom and Milgrom, 1994). Commissions also allow firms to hire a larger number of new employees because the underproducing employees leave on their own volition when they are not receiving any compensation for their labor. Commissions (like mutual fund loads with breakpoints and 12b-1 fees) have also proven to be somewhat shrouded to individual investors (Beshears et al., 2009; Malmendier and Shanthikumar, 2007), and if consumers perceive fewer costs associated with a product or service they will demand more of it.

Asset fees have their own advantages and disadvantages. Firms that charge asset fees can anticipate revenue streams more accurately, and benefit from increasing economies of scale. Clients feel more comfortable and secure with advisor recommendations because the advisor's compensation is tied to the actual performance of the underlying investments. If advisors lose half a client's money, they also lose half their revenue stream. While virtually all Registered Investment Advisor (RIA) firms in the United States charge a percentage of assets under management (98.5%), only a small portion of RIA firms receive compensation

in the form of commissions¹ (12.7%). The prevalence of assets under management (AUM) fees suggests that this is by far the preferred form of compensation for RIA firms. Considering the operational benefits of the expected annual revenue stream and the increasing economies of scale associated with managing more assets, the advantages of this form of compensation to the firm are evident. However, there are disadvantages to clients associated with charging a percentage of assets under management. The most common criticism is that firms compensated based on assets will be less likely to provide advice that would decrease the assets under management. The recent regulatory changes in Australia and England highlight another concern with asset fees that could have larger ramifications in a policy context. A recent RAND research study sponsored by the SEC determined that RIAs reported not providing service to many investors because the investors could not meet the account minimums (Hung, Clancy, Dominitz, Talley, Berrebi, and Suvankulov, 2008). More than half the RIA firms responding to the survey indicated a minimum requirement of \$1 million in investable assets. A small number of firms are willing to have account minimums between \$100,000 and \$500,000, and the authors reported typical fee structures of 1.25% for assets under \$1 million, 1% for \$1M–\$5M, 0.75% for \$5M–\$10M, and 0.25% for more than \$10M (pg. 73). Therefore, the typical RIA firm charging a percentage of AUM needs a minimum expected income stream of at least \$10,000 annually to accept a client. According to recent data from the Survey of Consumer Finances (SCF), fewer than 22% of American workers have more than \$100k in savings and investments, and only 11% have more than \$250k (Helman, Copelan, and VanDerhei, 2010). When the sample is limited to retirees, only 27% report having more than \$100k and 42% report having less than \$10k (Helman et al., 2010). A survey of 661 Certified Financial Planners indicates that their clients had a mean annual income of \$131,000 and a median net worth of \$390,000 (Certified Financial Planner [CFP] Board of Standards 1999). Data from the 1998 SCF suggests that only one in five Americans uses professional investment advice (Elmerick, Montalto, and Fox 2002).

RIA firms appear to cater to a small (but very high net worth) slice of the U.S. population. Even for the few firms willing to accept lower to moderate net worth clients with \$100,000 in investable assets with a 1.25% AUM fee, the minimum annual compensation is expected to be at least \$1,250 per year, a cost that some consumers may be unwilling to pay.

In contrast, the authors of the RAND research report also examine broker-dealers who are primarily compensated via commissions and find that more than half of them had *no* account minimums and are willing to assist investors with small sums (pg. 69). The broker-dealers' willingness to serve clients without any minimum investment amount suggests that the commissions from the current transaction(s) are sufficient compensation for their services.

It is possible that low net worth clients are willing to pay a relatively high portion of their investable assets as commissions because the fees associated with the service are opaque (Gabaix and Laibson, 2006). Even highly educated consumers examining simplified disclosure documents do not understand the impact of a mutual fund load (Beshears, Choi, Laibson, and Madrian, 2009) or mutual fund fees (Choi, Laibson, and Madrian, 2010; Gil-Baso and Ruiz-Verdu, 2009). Consumers tend to underreact to payments that are automatically levied and less easily perceived (Chetty, Looney, and Kroft, 2009; Finkelstein, 2009). It is plausible and even likely that the average consumer might be less willing to seek

professional financial advice if the fees associated with the advice are more salient or transparent to the consumer. Hung et al. (2008) find that broker-dealers tend to make the required compensation disclosures at the point of sale (that effectively shrouds the cost until the end of the client-agent interaction), as opposed to doing so at the beginning of their first meeting with the client when most RIAs make their required compensation disclosures.

There are effectively three parties involved when a principal seeks professional advice from an agent; the principal, the agent, and the agent's firm. This creates a dilemma where the agent has a duty to both the principal and the firm (Jackson, 2009). Compensation arrangements impact the incentives among the firm, agent, and client (Jensen and Meckling, 1994; Burton, 1994; Robinson, 2007; Golec, 1992; Record and Tynan, 1987). From the firm's perspective, a straight commission compensation arrangement creates incentive for its agents to be consistently productive for the firm (Kurland, 1991). For the client-agent relationship, a flat fee, hourly fee, or percentage of AUM creates incentive for the agent to provide higher quality advice. Information asymmetry between clients and agents creates its own incentive for experts to extract rents from clients who are unable to determine a low quality solution from a high quality solution (Dulleck and Kerschrammer, 2006). Shrouded costs like 12b-1 fees, dealer concessions, and commissions tend to be criticized because consumers do not realize the costs of the payments they make to the agent (Jackson, 2009).

Registered investment advisors with high net worth clients tend to prefer compensation schemes that will generate a long-term stream of income like wrap fees or a percentage of assets under management. Advisors who are solely reliant on these types of fees will be less likely to accept clients with low net worth because the amount of effort to advise the client and handle the compliance and regulatory requirements of assisting the client are not justified by the pecuniary benefits for doing so. Other compensation schemes like commissions, hourly charges, and fixed fees are more likely to provide an adequate incentive to assist low net worth clients. If a client only has \$10,000 in investable assets, it is unlikely that an advisor will spend the time and resources to develop a comprehensive financial plan and provide regular monitoring of the clients situation when a recurring fee of one percentage of the assets under management would net the advisor approximately \$100 annually in compensation. However, an advisor who charges commissions would be more willing to assist a client with \$10,000 to invest because they could conceivably receive up to 8.5% commission via the front load, up to 1% annually via the 12b-1 fee, and might also receive some additional remuneration from their employer in the form of bonuses, dealer concessions, or vacations, especially if the fund sold is a proprietary product where the firm can generate extra revenue from underwriting fees and captive management fees (Kurland, 1991).

3. Data description and methodology

As of July 2008, there was a total population of 11,226 investment advisory firms officially registered with the SEC. At that time (aside from a few exceptions), firms were required to have at least \$25 million in AUM to register with the SEC. Therefore, firms reporting less than \$25 million in assets under management are eliminated from the dataset, leaving 10,112 firms. A number of firms reported that they had no individual clients and are

Table 1 Assets under management by decile and number of accounts in RIA firms

	Assets under management	Median number of accounts
Min	\$25M	1
1st decile	\$25–\$35.6M	91.5
2nd decile	\$35.6–\$47.4M	125.0
3rd decile	\$47.4–\$62.3M	160.0
4th decile	\$62.3–\$83.3M	191.5
5th decile	\$83.3–\$115M	220.0
6th decile	\$115–\$168M	278.0
7th decile	\$168–\$269.2M	349.5
8th decile	\$269.2M–\$511.9M	464.0
9th decile	\$511.9M–\$1.414B	588.5
10th decile	\$1.414B+	1,029.0
Max	\$759,690,000,000	2,539,893
Median	\$115,000,000	231
Mean	\$2,128,520,110	2,354

Notes: This table gives firm size in the RIA population as of July 2008 by total assets under management and median number of accounts at the respective firms. The population consists of 10,112 RIA firms with individual clients and at least \$25M in assets under management (AUM), divided into deciles according to total AUM. The median number of accounts for each decile and some additional summary statistics including minimum, maximum, and mean values are also included.

removed from the sample, leaving 7,403 RIA firms in the United States with individual clients as the population for the current study. The firms in the population reported having a median of approximately \$115 million dollars in assets under management and approximately 231 accounts per firm (see Table 1).

To determine the average account size at each RIA firm, the total assets under management is divided by the number of accounts reported by each firm.

$$\text{Average account size} = \frac{\text{Total Assets Under Management}}{\# \text{ of accounts}} \quad (1)$$

To compare firms by average account size, this variable is categorized into deciles (see Table 2).

To measure whether certain forms of compensation are associated with different account sizes, we use a combination of descriptive techniques and multivariate analyses. An analysis of variance (ANOVA), standardized *t* tests, and χ^2 analyses are used to identify whether different forms of compensation are more prevalent for certain account sizes and types of clients. The initial findings using our constructed variable of average account size are cross-checked using RIA firms' self-reporting of the proportion of their clients that have a high and low net worth.

A multivariate binary logistic regression analysis is performed for each type of compensation to examine the predictors of compensation type including proportion of low net worth clients, proportion of high net worth clients, account size, assets under management quintiles, provision of financial planning services, provision of portfolio management, and number of employees. Separate regressions are run to test different proxies for client wealth, including the proportion of high net worth clients, proportion of low net worth clients, and average

Table 2 Average account size by decile

	Average account size	Median number of accounts
1st decile	< \$148,737	575.0
2nd decile	\$148,737–\$218,742	368.5
3rd decile	\$218,742–\$292,601	344.0
4th decile	\$292,601–\$396,425	280.0
5th decile	\$396,425–\$541,673	214.0
6th decile	\$541,673–\$779,221	185.5
7th decile	\$779,221–\$1,171,259	150.0
8th decile	\$1,171,259–\$2,083,535	116.0
9th decile	\$2,083,535–\$6,259,705	91.0
10th decile	> \$6,259,705	40.0
Max	\$14,402,491,336.50	2,539,893
Median	\$541,673.48	231
Mean	\$10,853,630.71	2,354

Notes: This table gives average account size in the RIA population as of July 2008 and median number of accounts at the respective firms. The population consists of 10,112 RIA firms with individual clients and at least \$25M in assets under management (AUM), divided into deciles according to average account size that is measured by dividing the total AUM of each firm by the number of accounts at each firm. The median number of accounts for each decile and some additional summary statistics including maximum, and mean values are also included.

client account size deciles. Separate regressions are run for RIA firms with primarily high net worth clients and RIA firms with primarily lower net worth clients. For these analyses, RIA firms serving primarily high net (low) worth clients are defined as having most of their clients (greater than 50%) identified as high (low) net worth clients. Coefficients for one may not necessarily be significant for the other because RIA firms serve a variety of clients: high net worth individuals, lower net worth individuals, banking institutions, charities, investment companies, pension plans, pooled investment vehicles, corporations, businesses, and municipal government entities. The Form ADV³ requires RIA firms to indicate what percentage of their clients comes from each of the aforementioned groups. Based on their responses, categories were collapsed into three categories: (1) fewer than 10%, (2) between 10 and 50%, and (3) more than 50% of clients being high net worth or low net worth, respectively.

4. Results

4.1. Descriptive

Almost all the investment advisors charge their clients based on a percentage of assets under management ($n = 7,294$ [98.5%]), and most receive compensation in multiple forms ($n = 5,743$ [77.6%]) in addition to the percentage of assets under management. A large number of firms receive compensation via other means like fixed fees ($n = 3,953$ [53.4%]), hourly charges ($n = 3,549$ [47.9%]), performance-based fees ($n = 1,182$ [16%]), commissions ($n = 943$ [12.7%]), subscription fees (102 [1.4%]), and other fees ($n = 663$ [9%]). Fig. 1 depicts the amount of RIA firms charging various forms of compensation

Figure 1 The percentage of RIA firms using specific fee types within each account size decile

Fee type (%)	1 st	2 nd	3 rd	4 th	5 th	6 th	7 th	8 th	9 th	10 th
AUM only (21.6%)	15.3	15.7	16.5	20.5	22.3	25.0	29.3	27.8	26.2	17.8
Commissions (12.7%)	23.9	18.5	20.5	16.5	12.3	9.5	8.9	8.1	5.8	3.4
Hourly charge (47.9%)	68.6	70.3	64.9	60.9	53.2	49.1	42.7	33.6	23.0	13.1
Fixed fee (53.4%)	58.0	63.2	63.6	57.0	52.4	52.3	49.6	49.8	47.4	40.7
Subscription fee (1.4%)	3.1	1.2	1.3	.7	2.2	.8	1.2	1.4	1.1	.7
Performance-based fee (16%)	5.9	6.1	5.5	8.5	8.5	13.0	11.6	17.1	29.1	54.3
Other (9%)	13.1	9.7	9.0	8.6	7.3	8.1	7.6	8.1	7.8	10.1

Note: SEC required hedge funds to register as RIAs (see Hung et al., 2008). Hedge funds generally have ultra-high account minimums and therefore the 10th decile of RIA firms by account size tends to produce slightly irregular responses when compared to more traditional RIA firms.

and demonstrates how RIA firms with different account sizes prefer different forms of compensation (see Fig. 1).

Fig. 1 indicates that the proportion of RIA firms charging commissions in the lowest account size decile is seven times higher than the highest decile (23.9% vs. 3.4%). For RIA firms with the lowest average account sizes, commissions are charged by almost one-fourth of the firms whereas less than 4% of the firms with the highest average account sizes charge commissions. The most common compensation arrangements available at RIA firms with the smallest account sizes are hourly fees (68.6%), fixed fees (58%), and commissions (23.9%); with AUM only (15.3%) being slightly more common than ‘other’ (13.1%) compensation arrangements.

Commissions are more prevalent than AUM only in the three lowest deciles, but AUM only becomes more prevalent as the deciles increase. The percentage of RIA firms that charge commissions falls consistently with higher account sizes. Similar findings are also produced by hourly fees and fixed fees. The opposite effect is apparent when examining performance-based fees and RIA firms that charge AUM only. In general, Fig. 1 appears to indicate that commissions, fixed fees, and hourly fees are more common for smaller account sizes whereas AUM only and performance-based fees are more common for larger account sizes.

Table 3 shows RIA firms with different account sizes tend to prefer different forms of compensation, a χ^2 analysis is conducted. The lower deciles represent smaller average account sizes or moderate net worth clients, and the larger deciles represent clients with increasingly more net worth or investable assets as measured by the average assets per account at each RIA firm. Table 3 presents the results of this χ^2 analysis and indicates which types of compensation are used significantly more or less than expected according to the average account size per firm.

Commissions, hourly charges, and fixed fees are significantly more prevalent in RIA firms with smaller account sizes, whereas AUM only and performance-based fees are significantly more prevalent in RIA firms with larger account sizes. Other forms of compensation are only found to be significantly more prevalent among the smallest account size decile. Similar to other fees, subscription fees are only found to be significantly more prevalent than expected within the smallest account decile.

Table 3 Type of compensation by average account size (percentage of firms that charge this fee)

Average account size decile	Type of compensation						
	AUM only (21.6%)	Commissions (12.7%)	Hourly charge (47.9%)	Fixed fee (53.4%)	Subscription fee (1.4%)	Performance-based fee (16%)	Other (9%)
1st	-	+	+	+	+	-	+
2nd	-	+	+	+		-	
3rd	-	+	+	+		-	
4th		+	+	+		-	
5th			+			-	
6th	+	-				-	
7th	+	-	-	-		-	
8th	+	-	-	-			
9th	+	-	-	-		+	
10th	-	-	-	-		+	

Notes: This table presents the results of a χ^2 analysis indicating which types of compensation are significantly more or less frequent according to the average account size per firm. The data is comprised of the entire population of 10,112 RIA firms with individual clients and at least \$25M in AUM as of July 2008 as reported to the SEC.

RIA firms must report what percentage of their clients are “high net worth individuals,” and what percentage of their clients are “individuals, other than high net worth individuals.” The SEC instructions indicate that individuals having more than \$750,000 in savings and investable assets are to be considered a high net worth client. For the purposes of the analysis, firms that report more than 50% of their clients being high net worth individuals are considered to be firms with primarily high net worth clients. Firms that reported more than 50% of their clients as individuals other than high net worth are considered to be firms with primarily moderate net worth clients.²

Table 4 depicts the types of compensation listed on the Form ADV. For each form of compensation, a standardized *t* test is conducted to determine if there are significant differences in the dependent variables (average account size, proportion of high net worth clients, and proportion of low net worth clients) when compared according to type of compensation.

Because almost all firms (98.5%) charge assets under management, a special group is constructed for this analysis that consists of the firms that charge *only* a percentage of assets under management and do not receive any other form of compensation. This group is referred to as AUM only and consists of 1,602 firms (or 21.6% of the sample). As expected, firms that charge AUM only report having significantly higher average assets per account, a significantly higher proportion of high net worth clients, and a significantly lower proportion of low net worth clients. The average account size for AUM only firms is over 76% larger than the average account size of firms that charge in ways other than, or in addition to, a percentage of assets under management.

Firms charging commissions report significantly lower average assets per account, significantly lower proportions of high net worth clients, and significantly higher proportions of low net worth clients. The average account size at firms that charge commissions is under

Table 4 Form of compensation by average account size and proportion of firms reportedly having primarily high and low net worth clientele

	<i>n</i>	Mean	Median	Proportion of firms with primarily high net worth clients	Proportion of firms with primarily low net worth clients
Total Sample	7,403	\$10,853,631	\$541,673	41%	35%
AUM only					
Yes	1,602	16,428,363*	695,663	45%***	30%***
No	5,801	9,314,116	502,232	39%	36%
Commission					
Yes	943	2,856,579*	296,098	27%***	49%***
No	6,460	12,021,002	603,284	43%	33%
Hourly fee					
Yes	3,549	2,135,620***	350,067	35%***	44%***
No	3,854	18,881,711	935,267	46%	27%
Fixed fee					
Yes	3,953	6,110,363***	457,317	41%	38%***
No	3,450	16,288,453	658,139	41%	32%
Performance-based fee					
Yes	1,182	28,202,691***	2,338,790	45%***	18%***
No	6,221	7,557,281	459,896	40%	38%
Subscription fee					
Yes	102	4,165,375	435,492	23%***	46%**
No	7,301	10,947,070	543,255	41%	35%
Other					
Yes	663	70,980,819**	459,187	37%***	38%**
No	6,740	9,857,440	545,993	41%	35%

Notes: Table 4 compares compensation types listed on the Form ADV that RIA firms are required to file with the SEC. Proportion of firms with primarily low or high net worth clients is calculated by filtering for firms that report having more than 50% of their clients classified as either high or low net worth clients, respectively. The population includes all 7,403 RIA firms with over \$25M in AUM that report having over 50% of their clients classified as either being primarily high or low net worth clients.

Coefficients marked ***, **, and * are significant at the 0.001, 0.01, and 0.05 levels, respectively.

\$3 million, whereas the average account size at firms that do not charge commissions is over \$12 million. Firms that do not charge commissions tend to have clients with an average account size that is more than four times larger than RIA firms that charge commissions.

Table 4 also demonstrates that other forms of compensation like hourly fees and fixed fees are associated with firms that have a greater proportion of low net worth clients and smaller average account sizes per firm. In fact, all forms of compensation are associated with a greater proportion of low net worth clients except for two forms: percentage of AUM and performance-based fees. Fixed fees are not associated with the proportion of high net worth clients, but commissions, hourly fees, subscription fees, and other forms of compensation are all associated with a lower proportion of high net worth clients.

4.2. Multivariate

Results from logistic analysis of the likelihood of different forms of compensation by account size deciles are presented in Table 5. The likelihood of charging commissions

Table 5 Binary logistic regression results for RIA firms by account size deciles

	AUM only	Commissions	Hourly charges	Fixed fees	Performance based fees	Other
Account size deciles (vs. 1st)	—	—	—	—	—	—
2nd decile	-.010	-.303*	0.151	0.234*	0.014	-.323
3rd decile	0.029	-.151	-.118	0.216	-.098	-.415*
4th decile	0.060	-.238	-.073	0.100	0.379	-.362*
5th decile	0.033	-.499***	-.349**	-.022	0.352	-.485**
6th decile	0.147	-.710***	-.464***	0.014	0.823***	-.337
7th decile	0.186	-.674***	-.504***	0.040	0.605**	-.362
8th decile	-.046	-.686***	-.773***	0.167	0.978***	-.256
9th decile	-.239	-.961***	-1.151***	0.146	1.557***	-.278
10th decile	-.757***	-1.530***	-1.428***	-.083	2.390***	-.125
AUM quintiles (vs. 1st)						
2nd AUM quintile	-.056	-.037	0.169	0.123	-.136	0.092
3rd AUM quintile	-.072	-.227*	0.037	0.251**	-.116	0.032
4th AUM quintile	-.063	-.420***	0.018	0.571***	-.288*	-0.032
5th AUM quintile	-.332*	-.829***	-.052	0.853***	-.215	-0.132
Provide financial planning services	-2.225***	1.015***	2.469***	1.854***	-.879***	0.584***
Provide portfolio management	0.853***	-.441	-.303	0.031	-.074	-1.059***
# of employees	-.148***	0.484***	-.172***	0.074*	0.360***	0.256***
Constant	-.932***	-1.869***	-.698**	-1.401***	-2.311***	-1.589***

Notes: Table 5 presents the binary logistic regression analysis examining the likelihood that an RIA firm accepts certain forms of compensation based on the account size deciles.

Coefficients marked ***, **, and * are significant at the 0.001, 0.01, and 0.05 levels, respectively.

decreases consistently with average account size. Advisors who cater to higher net worth clients are also less likely to use hourly charges. Account size seems to have little impact on whether an advisor charges fixed fees, and charging assets under management is only less likely in the highest account size decile. Advisors who cater to high net worth clients are far more likely to charge performance-base fees. Firms with more assets under management are less likely to charge commissions and more likely to charge fixed fees. Those who provide financial planning services are more likely to charge commissions, hourly charges, fixed fees and other forms of compensation, and less likely to charge AUM and performance-based fees. While commissions are negatively associated with larger account size clients and firms with more AUM, they are positively associated with firms that have more employees.

Table 6 presents logistic results using the proportion of low net worth clients rather than account size deciles. Consistent with results from the net worth deciles, investment advisors who use commissions and hourly charges as compensation are more likely to have low net worth clients. Advisors who charge performance-based fees are less likely to have low net worth clients. Other results are similar to the previous regression.

Logistic analysis of compensation type using proportion of high net worth client categories are presented in Table 7. As expected, advisors who cater to a greater proportion of high net worth clients are less likely to charge commissions and hourly fees. Advisors who charge performance-based fees are more likely to cater to high net worth clients. As with the previous regression, results from other control variables are similar.

Table 6 Binary logistic regression results for RIA firms with low net worth clients

	AUM only	Commissions	Hourly charges	Fixed fees	Performance based fees	Other
Proportion of LNW clients (vs. <10%)						
11–50% low net worth clients	0.124	0.313**	0.662***	0.124	–.808***	0.029
>50% low net worth clients	0.081	0.501***	0.809***	0.135	–1.240***	–.005
AUM quintiles (vs. 1st)						
2nd AUM quintile	–.073	0.015	0.136	0.123	–.035	0.075
3rd AUM quintile	–.097	–.285*	–.034	0.258**	0.015	–.009
4th AUM quintile	–.126	–.561***	–.140	0.587***	–.043	–.091
5th AUM quintile	–.607***	–1.188***	–.458***	0.851***	0.486***	–.143
Provide financial planning services	–2.156***	1.175***	2.601***	1.851***	–1.174***	0.563***
Provide portfolio management	1.153***	–.199	–.058	0.065	–.592***	–1.159***
Number of employees	–.137***	0.527***	–.116**	0.070*	0.310***	0.264***
Constant	–1.326***	–2.945***	–1.900***	–1.446***	–.392	–1.755***

Table 6 presents the binary logistic regression analysis examining the likelihood that an RIA firm accepts certain forms of compensation based on the proportion of low net worth clients at the firm.

Coefficients marked ***, **, and * are significant at the 0.001, 0.01, and 0.05 levels, respectively.

Table 7 Binary logistic regression results for RIA firms with high net worth clients

	AUM only	Commissions	Hourly charges	Fixed fees	Performance based fees	Other
Proportion of HNW clients (vs. <10%)						
11–50% high net worth clients	–.130	–.178	0.082	0.521	0.263*	–.069
>50% high net worth clients	0.003	–.580***	–.408***	2.744	0.436***	–.098
AUM quintiles (vs. 1st)						
2nd AUM quintile	–.064	0.031	0.140	0.117	–.066	0.082
3rd AUM quintile	–.102	–.272*	–.062	0.234**	0.082	0.004
4th AUM quintile	–.144	–.538***	–.196*	0.536***	0.118	–.068
5th AUM quintile	–.639***	–1.209***	–.620***	0.775***	0.837***	–.118
Provide financial planning services	–2.136***	1.239***	2.685***	1.876***	–1.339***	0.563***
Provide portfolio management	1.174***	–.099	0.148	0.088	–.867***	–1.145***
Number of employees	–.131**	0.514***	–.099**	0.089**	0.238***	0.254***
Constant	–1.226***	–2.482***	–1.452***	–1.447***	–1.026***	–1.697***

Notes: Table 7 presents the binary logistic regression analysis examining the likelihood that an RIA firm accepts certain forms.

Coefficients marked ***, **, and * are significant at the 0.001, 0.01, and 0.05 levels, respectively.

5. Conclusions

This study investigates the relation between investment advisor compensation method and client wealth. Investment advisors who cater to low net worth clients are more likely to charge for their services through commissions and hourly fees. The form of compensation most prevalent among investment advisor firms with high net worth clients is performance-based fees. Investment advisors who are compensated through commissions are more likely to provide financial planning services, have a larger number of employees, and have lower assets under management.

When England and Australia recently banned commissions on financial products, opponents argued that doing so will negatively impact lower net worth clients and will reduce the number of professionals providing financial advice. The results from this study support this hypothesis. Robinson (2007) argues that while there are obvious conflicts of interest associated with commissions, perhaps the differences in regulation between RIAs with a fiduciary standard and broker-dealers operating under a suitability standard account for a majority of the negative sentiment towards commissions. If that is the case, eliminating commissions (that will affect low net worth clients and a large number of professionals) might not be as fruitful as promoting a fiduciary standard of care and increasing the competency requirements for investment advisors. Doing so would eliminate the inconsistencies created by having two separate sets of regulation for financial advisors in the United States (see Wall and Eisenbeis, 2000).

The finding that performance-based fees are significantly more likely among the wealthiest investors is partially tied to the inclusion of some hedge funds in the RIA database, but this is not the only reason for this finding. A few nonacademic articles in the investment industry have suggested that after the recent financial crisis, ultrawealthy clients have shifted to demanding performance-based fees (e.g., fulcrum fees) where the advisor receives less or nothing when the portfolio underperforms and receives more compensation when it outperforms the market. This form of compensation has its own inherent conflicts of interest (advisor incentive to seek risk) that may be related to behavioral biases of clients who are averse to paying a professional when they lose money, but have little or no problem paying extra when returns are good (see Benjamin, 2010; Dunham, 2008).

Fixed fees are not associated with account size, but are associated with larger firms (more AUM). An article about the future of fees in the RIA industry (Opiela, 2006) argues that for an RIA firm to shift to a retainer fee in lieu of AUM, it needed to be a large practice with high-net worth clients and long-term client relationships. According to our findings, having high net worth clients is not as essential as the size of the practice for using fixed fees or retainers. While the fixed fee or retainer fee does eliminate some of the perceived conflicts of interest created by charging a percentage of AUM, it appears that an RIA firm has to be quite large to effectively use this form of compensation.

Hourly charges are significantly associated with having a greater proportion of lower net worth clients, and negatively associated with having more high net worth clients. Among the two lowest account size deciles, approximately 70% of RIA firms use hourly charges compared with less than 20% of RIA firms in the two highest account size deciles. Hourly charges are more likely to be used in smaller firms with fewer employees, smaller account

sizes, and lower assets under management. The hourly charges are a transparent form of compensation and allow professionals to work with a broader base of clients who have various needs for professional advice but might not have the investable assets necessary for other forms of compensation (Opiela, 2000; Opiela, 2006). However, hourly charges can be irritating to professionals who have to keep track of the time they spend, and can discourage clients from calling for advice when they might need it.

Notes

- 1 Although commissions are charged by only 12.7% of RIA firms with individual clients, they account for 38.6% of all accounts.
- 2 Although it is important to note that while we do not know the actual net worth of these clients it is safe to assume, based on the account size deciles in Table 2, that most of these clients are actually “low to moderate” net worth clients, but to facilitate the summation of findings these clients will henceforth be referred to as “lower net worth” in lieu of the more cumbersome Form ADV version of “individuals other than high net worth.”
- 3 The survey instrument is the Form ADV (Part 1 and 2) that RIA firms file with the SEC. To see a copy of the survey instrument, see the Forms for IARD section of the SEC website: <http://www.sec.gov/divisions/investment/iard/iastuff.shtml>

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