Conflict of Interest Disclosure Effectiveness: A Regulatory Perspective

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Barriers to Conflict Disclosure Effectiveness

1. Complexity
2. Inertia and Social Influence
3. Advisor and Advisee Distortions

Mock Form ADV Conflict Disclosure from Dodd-Frank 2012 Financial Literacy Study:

> "XYZ Financial may choose to recommend managers and investment products for which XYZ Financial or one or more of its affiliates serve as broker, prime broker, counterparty, administrator, or other service provider, including investment banking, placement agent, or secured lender and with respect to which XYZ Financial and/or its affiliates receive fees, interest and/or other compensation. XYZ Financial, in the course of these activities, including its prime broker and secured or margin lending activities, may take actions that are adverse to the interest of its advisory client, such as foreclosing upon collateral comprised of assets of an investment product pledged with respect to a loan."

Dodd-Frank Financial Literacy Study

- Form ADV Brochure Panel, Fees/Compensation Module:
  - Adviser ABC: asset and performance-based fee
  - Adviser XYZ: asset and commission-based fee
  - 22.6% identified XYZ as having worse conflicts versus 18.6% for ABC and 42% for neither advisor

- Conflicts of Interest Module:
  - Adviser ABC: soft dollars
  - Adviser XYZ: soft dollars + 12b-1 fees, affiliated funds, etc.
  - 22.7% identified ABC as giving less biased advice versus 16.8% for XYZ, 22.5% both biased, and 16.2% neither biased;

Inertia and Social Influence

- 50% of survey respondents identified advisor through referral from family or friends and 29.7% from financial professional.

- Respondents who recall receiving Form ADV brochure (68.5%), reading it (58%), discussing it (50%); adviser provided fee disclosure (74%).

Behavioral Distortions

- **Advisee distortions:** over or under-reaction to conflicts (Cain, et al., 2005), panhandler effect (Sah, et al., 2013), etc.

- **Advisor distortions:** moral licensing (Cain, et al., 2005), etc.

Improving Conflict Disclosure Effectiveness

1. Simplification
2. Increasing Salience
3. Non-disclosure based Interventions

Simplification

- Kling, et al. (2012) found that senior citizens reduced Medicare costs after receiving a letter with personalized, standardized, and comparative cost information (incumbent versus the lowest-cost plan).

- FCA Asset Management Market Study (2017) recommends disclosure of a single “all-in” fee (including asset management and estimated transaction charges).

Salience WARNING!

Several studies show effects from increasing salience of disclosures by:

- Preferential ordering of items (e.g., Luca and Smith, 2013; Hewitt, Watkins, and Yohn, 2017)
- Excluding less relevant information (Hastings and Tejada-Ashton, 2008)
- Incorporating images and color (e.g., Sobani, et al. 2010; Bazley, Cronqvist, and Mormann, 2017)

Non-Disclosure Based Interventions

- Church and Kuang (2009) experiment finds that conflicts disclosure is not necessarily detrimental:
  - Advisors are no more biased with disclosure if advisees have choice. Investors are better off when conflicts are disclosed and sanctions are available.
  - This study suggests the effectiveness of legal standards of care and enforcement in combination with disclosure.
- Can education and outreach increase awareness and understanding of conflicts? Can technology help (Loewenstein, Sunstein, and Golman, 2014)?

Questions?

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