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Consumer Protection in Markets with Advice

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Economists have long been interested in the performance of markets with imperfect information—and in the role of intermediation services in bridging the information gap between product providers and customers. Still, the classic information-economics framework for studying markets may fail to account for another role through which advice can affect market efficiency. Customers may suffer from "behavioral biases" in how they process information and make decisions. Thus, it is natural to ask whether advisors help households make better decisions or whether they, instead, exploit the biases and naïveté of their customers.

In this article we present some of the reasons why markets with advice may malfunction, and explore the potential rationales for some of the policy proposals that are on the table. We focus on the role of mandatory disclosure policies, the regulation of cancellation terms for service contracts (and refund policies for products), the imposition of liability standards for product providers and intermediaries, and the outright regulation of the size and structure of commissions.

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I. Introduction

The recent subprime mortgage debacle has generated active debate on the role of the advice households receive from brokers and other information intermediaries when purchasing mortgages and other financial services such as consumer credit, life insurance, and investment products. In the current legislative proposal to reform investor protection and establish a Consumer Financial Protection Agency ("CFPA") in the United States, advice features prominently:

> "Impartial advice represents one of the most important financial services consumers can receive . . . Mortgage brokers often advertise their trustworthiness as advisors on difficult mortgage decisions. When these intermediaries accept side payments from product providers, they can compromise their ability to be impartial. Consumers, however, may retain faith that the intermediary is working for them and placing their interests above his or her own, even if the conflict of interest is disclosed. Accordingly, in some cases consumers may reasonably but mistakenly rely on advice from conflicted intermediaries. It is unfair for intermediaries to take advantage of that trust.
>
> To address this problem, we propose granting the CFPA authority to impose carefully crafted duties of care on financial intermediaries. For example, the CFPA could impose a duty of care to counteract an intermediary's patent conflict of interest, or to align an intermediary's conduct with consumers' reasonable expectations as demonstrated by empirical evidence. The CFPA could also consider imposing on originators a requirement to disclose material information such as the consumer's likely ability to qualify for a lower interest rate based on her risk profile. In that regard, the CFPA could impose on mortgage brokers a duty of best execution with respect to available mortgage loans and a duty to determine affordability for borrowers."[1]

The United Kingdom, Germany, and many other jurisdictions are also considering the introduction of new regulation and policies in the face of potentially widespread "misselling" of retail financial services.[2]

The problem of unsuitable advice is clearly not confined to the financial industry—although the common use of commissions in that industry as well as the lack of customer sophistication ("financial capability") certainly aggravate the problem. Outside the financial industry, for instance, payments and gifts made by pharmaceutical companies to physicians are also attracting closer scrutiny around the world, driven by concerns about both consumer protection and bulging health budgets.[3] In fact, many of the current policy proposals in the area of retail finance, such as the disclosure of commissions and other inducements, are also being debated or have already been enacted for the provision of medical services.[4]

Economists have long been interested in the performance of markets with imperfect information—and in the role of intermediation services in bridging the information gap between product providers and customers. Still, the classic information-economics framework for studying markets may fail to account for another role through which advice can affect market efficiency. Customers may suffer from "behavioral biases" in how they process information and make decisions. Thus, it is natural to ask whether advisors help households make better decisions or whether they, instead, exploit the biases and naïveté of their customers.[5]

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In this article we present some of the reasons why markets with advice may malfunction, and explore the potential rationales for some of the policy proposals that are on the table.[6] We focus on the role of mandatory disclosure policies, the regulation of cancellation terms for service contracts (and refund policies for products), the imposition of liability standards for product providers and intermediaries, and the outright regulation of the size and structure of commissions. For examples of such policies, consider the following:

- As part of their occupational licensing procedures, various U.S. states require mortgage brokers to maintain a minimum net worth or to post a "surety bond."[7] The risk of losing this surety bond—or the imposition of penalties or close scrutiny by supervisory authorities and professional associations—should have a disciplining role on the market for advice.[8]

- There is presently a lively debate about regulating the structure of payments to those who sell financial products to households.[9] To better align the interests of customers with those of their advisors, regulation could impose limits on the fraction of an advisor's commission that is paid up-front instead of over the duration of a contract ("trail commission"). Intervention could also be directed at banning commissions altogether and steering the industry toward a more direct form of compensation for advice (for example, through hourly fees).

- Policies mandating the disclosure of payments between product providers and intermediary agents have been commonly adopted. In November 2008 the U.S. Department of Housing and Urban Development strengthened the requirement imposed on third-party brokers to disclose the payments they received for intermediated mortgage agreements to homeowners.[10] Also, in 2008, the Federal Trade Commission proposed rules that would require brokers to join with customers in an initial agreement that:

> "must state that the consumer will pay the entire compensation even if all or part is paid directly by the lender, and that a lender's payment to a broker can influence the broker to offer the consumer loan terms or products that are not in the consumer's interest or are not the most favorable the consumer could obtain."[11]

The article proceeds as follows. Section II discusses in detail the role of advice in markets for retail financial services, our leading example. Providing reliable advice may be essential to ensure that retail financial services provide benefits to a wide range of consumers. Section III discusses various policy interventions. While the discussion of specific policies is dictated by the current debate, these policies generally fall into three groups:

1. Policies that aim at reducing the need for advice, either by improving the quality of information or sophistication of consumers or by reducing the (perceived) complexity of products and services;

2. Policies that ensure that the quality of advice improves, e.g., by requiring that advisors meet higher standards of qualification or that they are given appropriate incentives to gather information and provide unbiased advice; and

3. Policies that target the way consumers deal with advice, for instance, through the provision of information about advisors' incentives.

Section IV offers concluding remarks.

II. Financial Advice to Households

Currently, in the United States, there is widespread concern about the quality of advice regarding consumer credit products, most notably subprime mortgages.[12] In Europe there seems to be an equal—if not greater—concern for the (mal)functioning of the market for retail investment services.[13] Although the role of advice may be equally important in other industries, here we're focusing on the example of retail financial services, describing some of the key issues.

A. PERVASIVENESS OF ADVICE

Advice is ubiquitous in the retail finance industry. In the United States, mutual funds and equities (apart from employer-sponsored plans) are overwhelmingly purchased after receiving financial advice.[14] According to a broad survey of retail investors in Germany, more than 80 percent of investors consult a financial advisor.[15] Further, a large cross-country survey in Europe showed that close to 90 percent of respondents in several countries expected advice to be provided by financial institutions—and the vast majority of customers said they trust the advice they received.[16] While these observations relate only to investment services, advice obviously also plays a key role in the market for credit products.[17] However, there is little evidence regarding how customers process financial advice, whether from banks or independent advisors.[18]

Until recently, despite its pervasiveness, the role of advice has been largely overlooked by much of the empirical literature that deals with the analysis of households' borrowing, saving, and investment decisions. The standard "household finance" paradigm features active investors who make individual decisions, possibly after acquiring costly information. That paradigm may describe some investors, most notably those trading frequently through online brokers,[19] but it fails to capture a key determinant of the behavior of other, less sophisticated investors who heavily rely on financial advice.

B. FINANCIAL CAPABILITY AND CUSTOMER BIASES

Many people seem to lack even a basic level of financial literacy. Policy studies have been conducted in several countries to map out possible ways to overcome this deficiency.[20] At the same time, it is not clear that even a substantial fraction of people are capable of learning and retaining the necessary concepts and tools to make informed financial decisions, in particular in the area of investments.

Many people seem to lack even a basic level of financial literacy.

In addition, financial capability may suffer less from a lack of knowledge than from decision-makers' "behavioral biases."[21] In fact, when making financial decisions, people suffer from the same mistakes they commonly make in other areas. For instance, they may be influenced by irrelevant aspects of the decision problem, such as the way in which the decision is presented (e.g., the format and material used to present the products).[22] Or, in order to save on decision-making costs, people apply (ill-suited) heuristics—which may work well in some situations but lead to serious mistakes in others. For instance, they may simply stick to the status quo or choose whatever option is provided as the default.[23]

Research in behavioral economics has recently pointed to various decision-making biases that may be particularly applicable to financial decisions. Some people procrastinate, delaying an action even though they are (or should be) aware that acting promptly would be better. A common explanation in cognitive psychology is that, for these people, immediate costs and benefits are unduly salient in comparison to future costs and benefits. People who are not aware of their tendency to procrastinate are liable to suffer significant welfare losses, e.g., as they incur high debt.[24]

A second bias is demonstrated by people who are myopically loss averse. They may see risks in isolation rather than considering the "whole picture," disregarding that a particular investment only accounts for a small fraction of their total wealth. Such a tendency may explain why some people shy away altogether from higher-risk investments such as stocks.[25]

Finally, behavioral biases in the way people process information may have important implications for the financial services industry. Some people may refrain altogether from investing when there are too many choices available, and the large array of different financial assets that retail investors have access to may generate just such "choice overload."[26]

Households' financial decisions may remain poor when they lack relevant knowledge or when they suffer from behavioral biases that affect how they process information. In the case of inadequate knowledge, the role of advice is immediate—households lacking financial sophistication should be willing to seek and follow advice. In the case of behavioral biases, advice could, in principle, be equally effective—in particular when the improvement of customers' decisions does not negatively impact the advisor's revenues.

C. PAYING FOR ADVICE AND CUSTOMER NAIVETÉ

It is common practice in the retail finance industry not to charge customers directly for advice, but for customers to pay indirectly for that advice through distribution fees, commissions, and other inducements that flow from product providers to brokers and (supposedly) independent financial advisors. These inducements often take the form of "kickbacks" that are not directly observed by the customers.[27] When advice represents, at least to some extent, a "credence good," then the value of that advice is potentially compromised by advisors' private interest in eliciting purchases.[28]

There is much anecdotal evidence that the fee structure of investment products, rather than their suitability, drives customer sales.[29] In the United States, evidence suggests that mutual funds sold through broker/agent networks underperform, and that funds with higher fees ("loads") are sold harder because of higher commissions, thus negatively affecting fund return.[30] Financial advisors may also have an interest in increasing the turnover in their clients' portfolio ("churning") when they earn additional fees or commissions with every new purchase.[31]

> THERE IS MUCH ANECDOTAL EVIDENCE THAT THE FEE STRUCTURE OF INVESTMENT PRODUCTS, RATHER THAN THEIR SUITABILITY, DRIVES CUSTOMER SALES.

The impact of commissions on the quality of advice depends not only on whether commission fees are made transparent to customers but also on customers' wariness. Do customers rationally evaluate the impact that such payments may have on a possible conflict of interest with their advisor and, thus, on the resulting quality of advice? Casual evidence indicates that not all customers are equally wary. In the United States, the Federal Trade Commission's staff report (2008) on disclosure rules for mortgage brokers suggests that "many consumers purportedly view mortgage brokers as trusted advisors who shop for the best loan for the consumer."[32] Findings in the academic literature support the view that some people are naïve about how the quality of advice is impacted by conflicts of interest. For example, studies of investors' reactions to analysts' recommendations suggest that at least some investors are naïve about analysts' incentives.[33] There is also some experimental evidence to the effect that many subjects are willing to blindly follow advice. Interestingly, even when subjects are informed about the divergence of interests between them and their advisors, this knowledge does not seem to always make them sufficiently wary.[34]

Findings in the academic literature support the view that some people are naïve about how the quality of advice is impacted by conflicts of interest.

III. Policies to Make Advice Work

Firms and intermediaries may have information that can lead customers to make better decisions. In this context, it is worth distinguishing between two broad scenarios. In the first scenario, the customer may be in a position to understand and, when necessary, validate the information obtained. The role of advisor is then essentially that of facilitator, who provides information to the customer in the most convenient way and subsequently assists with the transaction. Our discussion, however, mostly concerns a second scenario, in which the customer needs help in either fully processing the available product information or in overcoming behavioral biases in information-processing and decision-making. This customer is in a weaker position and must rely on the advisor's recommendation.[35]

A. HOW TO PAY FOR ADVICE

As we have noted, customers commonly pay "indirectly" for advice through higher product prices, some fraction of which is passed on to advisors in the form of commissions or other contingent payments. When a customer must rely on an advisor's recommendation at least to some extent, and when reputational or liability concerns are not sufficiently strong, this practice can lead to biased advice where the advisor biases his recommendations toward making a sale while favoring products that pay higher commissions.

Recent research seeks to analyze why this remuneration structure is dominant and persists, despite the inefficiency created by the bias. There is some evidence that some customers are not sufficiently wary of the conflict of interest that affects advice. In this case, in the equilibrium market outcome, customers are not charged a direct fee for advice but, rather, end up paying higher product prices. In turn, advisors are induced to provide biased advice through high commissions.[36] Intuitively, while customers fully take into account any additional amount that they have to pay up-front, they underestimate the likelihood of their ultimately purchasing the product and paying the corresponding price. Thus, providers have an incentive to charge for advice through a higher product price (paid contingent on purchase) rather than through an up-front fee (paid regardless the purchase). The business practice of not charging customers directly for advice then persists, whether or not firms enjoy market power and whether or not competition prevails, as long as customers remain naïve about the conflict of interest generated by the commission compensation. In this scenario, there is a positive role for policy intervention that makes customers sufficiently wary through a "warning" (see Section B below) or imposes restrictions on how advice is paid for.

In contrast, if customers are wary of the seller's strategic incentives, any policy that interferes with business practice is bound to reduce efficiency and ultimately reduce consumer surplus if competition is sufficiently intense. Moreover, there may be an efficiency rationale for the practice of paying advisors a higher margin when their advice results in a sale: A sales commission may induce advisors to acquire information by reading detailed material about particular products, keeping themselves informed about market developments, and acquiring customer-specific information so as tailor the advice toward the specific needs of their customer. When expecting to earn a commission only if the customer subsequently makes a purchase, the advisor may be motivated to work hard and may be able to credibly convince the customer with a superior recommendation. An advisor who, instead, is paid only a fixed fee (or is paid by the hour) and who has little at stake in business and reputation has a limited incentive to work hard.[37]

The prospect of policy interference by (for instance) mandating caps on commissions to force advisors to charge customers directly for their service should, thus, depend heavily on the perception of whether customers who buy the particular product through the particular sales channel are sufficiently wary of how advisors are compensated and how this compensation potentially compromises the value of the advice they're receiving.

B. DISCLOSING COMMISSIONS

Wary customers should discount advisors' recommendations to a greater degree when they must pay a high price for the respective product, given that they should rationally infer that the product provider pays a high commission to the advisor. In this case, product providers could benefit from not giving advisors steep incentives, thereby enhancing the quality of advice and increasing customers' willingness to pay for their products. However, out of a desire to push sales further, firms could provide advisors with additional, secret kickbacks. In such a situation the enforcement of a mandatory disclosure of commissions could benefit both firms and customers.[38]

Firms' and customers' incentives with respect to disclosing commissions are, however, no longer aligned when, without such disclosure, customers remain naïve about the conflict of interest. As we have noted, firms may then be able to maximally exploit customers by reducing any direct fees for advice and increasing both product prices and commissions. Naïve customers may, however, be made aware of the conflict of interest when firms are forced to disclose commissions or to provide a general "warning" that such commissions are paid and may compromise the quality of advice.[39]

Some recent experimental and theoretical work shows that mandatory disclosure of commissions may have unintended consequences. Customers who are unfamiliar with such disclosure may fail to make appropriate use of the disclosed information. In fact, this information may distract their attention from attractive product characteristics and induce them to choose inferior products associated with lower commissions.[40] Furthermore, disclosing commissions could undermine the trust relationship between advisors and clients. Advisors who experience mistrust from their customers may then feel "morally licensed" to maximize only their own profits.[41]

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In practice, such a possible "information overload" of customers or a change in the "framing" of the advice relationship may, however, have only temporary implications until customers and advisors adjust. More research is needed in this area. Research is also lacking on how advice works differently in face-to-face situations where it may be combined with high-pressure sales techniques.[42] Sales people who also provide advice may apply psychological tactics (or even make false claims) to build an image of expertise and use their influence to exert undue sales pressure on customers.[43]

Finally, it is important to bear in mind that besides steering advisors' recommendations toward particular products, commissions have a much wider range of purposes, such as rewarding intermediaries who prospect for new purchasers. Dampening commissions could also inefficiently interfere with any efficiency-enhancing functions that commissions serve, leading to negative welfare implications, e.g., by slowing the roll-out of products or preventing reaching certain segments of the market that require more sales effort.[44]

C. REGULATING CONTRACTS: COMMISSION AND PRODUCTS

In the wake of the financial crisis there is much debate on how to regulate compensation to better align the interests of top managers in financial institutions with those of society. The most common proposals are to limit the steepness of incentives and to make incentives longer term. Interestingly, these suggestions mirror some of the policies that have already been implemented for retail financial and insurance services. In fact, policymakers in a number of countries are pushing toward a higher share of trail commissions, and some countries have already taken steps in this direction.[45]

To our knowledge, economics research has paid little attention to the issue of the structure of commissions and its implications for consumer welfare. However, some of the more general insights regarding the (mandatory) disclosure of commissions, which we discussed above, apply here as well. Take the matter of up-front commissions versus trail commissions. Generally, when contracts are long-term and may be cancelled by consumers, or when the product provider can expect feedback from consumers over the long term, then the firm could better align the interests of customers with those of the agent by postponing part of an intermediary agent's commissions. Such an action may, however, be quite costly if the agent has a strong (time or liquidity) preference for being paid immediately. If customers are sufficiently wary and can observe the structure of commissions, they may correctly infer that more long-term and less short-term commissions should increase the quality of advice. Policies mandating the postponement of a given fraction of commissions may then serve for firms as commitment devices, much like the mandatory disclosure of commissions, and may provide disincentives for churning.

In markets where the quality of advice is the linchpin to deliver customer value, policies could be directed both toward increasing the quality of advice, e.g., by regulating the size and structure of commissions, and toward making advice less necessary. This latter goal could be achieved by either making the customer better informed and more sophisticated or by reducing the need for complex decisions. With respect to financial products, for example, a government's decision to privatize much of its pension system could substantially complicate households' decision problems but the increased complexity could be reined in through a pre-selection of providers and products that would enjoy preferential tax treatment. Regulation of products may also ensure that firms and their intermediary agents have incentives to provide better advice. We explore this next.

IN MARKETS WHERE THE QUALITY OF ADVICE IS THE LINCHPIN TO DELIVER CUSTOMER VALUE, POLICIES COULD BE DIRECTED TOWARD INCREASING THE QUALITY OF ADVICE.

Take the case of termination and cancellation clauses in contracts.[46] When customers need time before becoming sure a particular product or service is indeed suitable for their needs, they benefit from the right to return the product or to cancel the contract. When the initial decision to purchase a product or to enter into a contract is made under advice, the provision of generous rights of refund or cancellation can help the seller commit to high quality and fair advice. Intuitively, the margin lost from early cancellations (or returns) disciplines the seller to advise the customer to purchase only following the observation of a sufficiently favorable signal about the product's suitability. But this commitment mechanism again requires that customers are wary. If credulous customers put too much faith in an advisor's inflated statements, they may wrongly presume that it is very likely they will be unable to terminate a contract. Indeed, firms are aware of this possibility and can maximally exploit customers' misperceptions by granting them very unfavorable terms of refund and cancellation, which in turn leads to a low quality of advice.

Both consumer surplus and welfare can be increased through a policy that mandates a minimum level for consumers' right to cancel.[47] In fact, unconditional refund periods are commonly imposed for the sale of life insurance policies and annuity contracts (typically sold following advice) and are often combined with suitability rules.[48] Regulations of cancellation terms and "free-look periods" tend to apply to retail channels populated by more vulnerable buyers such as senior citizens who can easily fall prey to aggressive marketing techniques.[49]

D. OVERSIGHT AND LIABILITY

Conceptually, the problem of unsuitable advice has much in common with that of the provision of faulty or inferior products, ("lemons"). In addition to learning and reputational mechanisms, the market ameliorates the lemons problem through contractual provisions such as warranties that allow customers to return faulty products or have them repaired at the seller's expense. However, outright unsuitability or inferiority of advice is likely to be much more difficult to establish. Purely contractual solutions may then simply become insufficient. If customers are wary of this deficiency, both customers and firms can benefit if firms are incentivized to work toward higher standards; for example, through self-regulation or the oversight and interference of agencies that protect consumers.[50]

CONCEPTUALLY, THE PROBLEM OF UNSUITABLE ADVICE HAS MUCH IN COMMON WITH THAT OF THE PROVISION OF FAULTY OR INFERIOR PRODUCTS, ("LEMONS").

Recent research has analyzed the benefits of imposing higher liability standards and tighter oversight. A major, though often overlooked, determinant of the need for a more interventionist policy is the severity of the "internal" agency problem between a product provider and the agent who is responsible for offering advice. This agency problem becomes more severe when the same agent is responsible both for providing advice and for eliciting new sales, for example by prospecting for new customers. In economics terminology, the agency relationship then features "multiple-tasks," with possibly conflicting implications for the firm's incentive structure: High rewards for sales are needed to generate new prospective customers, but they lead to biased advice.

Hence, the appropriate standard of liability and oversight that agencies would want to impose should depend on how products are sold and advice is given. Also affecting the agency problem and the standard of advice that would prevail in equilibrium without policy interference is whether firms have access to early customer feedback, which in turn depends on customers' sophistication and the nature of the products.[51]

Further, when selling and advice of complex products are undertaken by independent agents, such as mortgage brokers or independent financial advisors, the question arises which party should be ultimately liable following an unsuitability claim. Clearly, some form of "vicarious liability" is called for when intermediary agents are unlikely to pay compensation to customers, given that their size and chosen organizational form make them essentially "judgment proof."[52] Policy makers must then decide which party should be responsible to implement their chosen standard of responsible selling.[53]

AND, IN THE LONG TERM, INCREASINGLY ACTIVE POLICY INTERVENTION MAY ACT AS A DISINCENTIVE FOR CUSTOMERS TO TAKE SUFFICIENT CARE THEMSELVES!

However, when tightening liability for particular products or channels, care must be taken to avoid unintended consequences. Product providers may simply cease to develop or roll out the products they deem to have high legal risk, irrespective of the ultimate benefits to customers. With respect to advice, agents may shift toward selling products without advice, even though customers may fail to understand the distinction.[54] Also, the special treatment of independent agents may distort the market by imposing a penalty on vertical separation and open-architecture sales. Such penalties can clearly distort competition and lead to less consumer welfare. And, in the long term, increasingly active policy intervention may act as a disincentive for customers to take sufficient care themselves!

IV. Conclusion

This article is a progress report on our current research that seeks to explain widely-observed compensation methods for advice and to analyze the effects of common policy measures that are meant to enhance the quality of advice. A key challenge is the intrinsic difficulty in evaluating the quality of advice tailored to the particular needs of customers. Quality level is important to understand not only for consumers but also for product providers, who may wish to implement a high standard of advice so as to be able to charge high product prices, as well as for policymakers and regulators.

In this respect, technological improvements in the way products are sold (such as through electronic platforms) may provide new opportunities for the industry as well as for policy makers. For example, the advent of smart agents might allow product providers to enforce rigid rules when giving personalized advice and to closely monitor internal compliance to chosen rules. At the same time, advances in information technology may also assist policy makers in developing more objective ways to evaluate and enforce the implementation of suitable rules.

However, particularly in the case of retail financial services, policy intervention may also be called for to establish reliable comparisons on how well customers fare when relying on advice from different sources.

Overall, more research is certainly needed to evaluate the costs and benefits of different policy interventions. To build policies on solid foundations, further theoretical, empirical, and experimental work must be done to better understand the role of advice in retail markets. Looking ahead, a particularly promising area is the integration of new advances from economics with marketing research. Case studies tailored to particular industries, products, and customer segments could also prove useful.

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1 Financial Regulatory Reform. A New Foundation: Rebuilding Financial Supervision and Regulation, U.S. Department of Treasury, 68, (June 2009).

2 In the EU, the regulation of retail financial sales and advice is framed by the Markets in Financial Instruments Directive (MiFID) and the Insurance Mediation Directive (IMD).

3 *See* M. Millenson, *Getting Doctors to Say Yes to Drugs: The Cost and Quality Impact of Drug Company Marketing to Physicians*, BlueCross, Blue Shield Association, (2003) for an overview of the practice of detailing drugs and physician preference items.

4 For instance, in the United States, the proposed Physician Payment Sunshine Act would require certain manufacturers of drugs and medical devices to report inducements given to physicians through consultant fees, educational grants, or travel gifts. According to this proposal, disclosure would go to the Secretary of Health and Human Services rather than to customers.

5 For example, financial advisors who are paid commissions may find it easier to increase revenues through "churning" when customers already have a bias toward excessive trading.

6 Broadly speaking, these policies fall into the area of consumer protection. Vickers defines consumer policy in terms of the underlying problems that it seeks to remedy, namely: (1) duress and undue sales pressure; (2) pre-purchase information problems; and (3) undue surprises after purchase. The topic of (unsuitable) advice covers all these problems, *see* John Vickers, *Economics for Consumer Policy*, Proceedings of the British Academy, 125, 287-310, (2004). However, in this article we will not address how consumer protection, sector specific regulation, and competition policy can jointly address these problems. We refer to Armstrong for a discussion of the interaction of competition and consumer policy, *see* Mark Armstrong, *Interactions Between Competition and Consumer Policy*, 4(1) Competition Pol'y Int'l, 97-145 (2008).

7 More precisely, as documented by Pahl, surety bonds are typically posted through third parties that initially check whether the broker has sufficient net wealth. While these third parties are the first to be liable, they are then compelled by regulation to seek redress from the broker, *see* C. Pahl, *A Compilation of State Mortgage Broker Laws and Regulations*, 1996-2006, Federal Reserve Bank of Minnesota, Community Affairs Report No. 2007-2.

8 The compensation that may have to be paid to customers once government agencies wade in and aggressively prosecute alleged misbehavior could be substantial. For instance, after a full review of private pension sales in 1994, financial institutions in the United Kingdom reportedly paid out a total compensation of £12 billion. In the more recent case of endowment mortgages, which bundle mortgages with risky (stock market) investment, U.K consumers have already obtained in excess of £2 billion in redress. For additional information, *see* the website of the U.K.'s Financial Services Authority (FSA) *at* www.fsa.gov.uk.

9 For instance, consider the following: "The CFPA should also be authorized to ban often invisible side payments to mortgage originators…that are tied to the borrower receiving worse terms than she qualifies for, if the CFPA finds that disclosure is not an adequate remedy. These payments incentivize originators to steer consumers to higher-priced or inappropriate mortgages. In addition, the CFPA could consider requiring that originators receive a portion of their compensation over time, contingent on loan performance, rather than in a lump sum at origination." *Financial Regulatory Reform. A New Foundation: Rebuilding Financial Supervision and Regulation*, U.S. Department of Treasury, 68, (June 2009).

10 For details, see www.hud.gov.

11 In the European Union, the Markets in Financial Instruments Directive (MiFID) has required since January 2008 the disclosure of commissions on retail financial products. In the United Kingdom, similar provisions were imposed earlier by the Financial Services Authority.

12 "Many borrowers whose credit scores might have qualified them for more conventional loans say they were pushed into risky subprime loans. . . . The subprime sales pitch sometimes was fueled with faxes and emails from lenders to brokers touting easier qualification for borrowers and attractive payouts for mortgage brokers who brought in business. One of the biggest weapons: a compensation structure that rewarded brokers for persuading borrowers to take a loan with an interest rate higher than the borrower might have qualified for." *Subprime Debacle Traps Even Very Credit-Worthy As Housing Boomed, Industry Pushed Loans To a Broader Market*, WALL STREET J., (December 3, 2007).

13 For updates on-going work by the EU Commission on the market for Packaged Retail Investment Products (PRIPs) *see* http://ec.europa.eu/internal_market/finservices-retail/investment_products_en.htm.

14 *See* D. Bergstresser, J. Chalmers, & P. Tufano, *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry*, REV. FINANCIAL STUDIES, forthcoming, and *Equity Ownership in America 2005* at http://www.ici.org/pdf/rpt_05_equity_owners.pdf). In a survey conducted by the Investment Company Institute (ICI 2007) over 80 percent of respondents stated that they obtained financial advice from professional advisors or other sources.

15 *See* DABANK, FASZINATION WERTPAPIER: FAKTEN UND HINTERGRÜNDE ZUM ANLEGERVERHALTEN IN DEUTSCHLAND, München, (2004). Two thirds respond that they obtain financial advice from their main bank. For a comparison, only one fifth (also) obtains advice from an independent financial advisor.

16 *See* Eurobarometer 60.2, Nov-Dec 2003. For instance, regarding households, 95 percent in Germany, 90 percent in Denmark, 95 percent in Austria, 91 percent in the Netherlands, and 80 percent in Finland expect to receive advice from financial institutions. (However, only 40 percent of Greek households expect to receive advice.) Furthermore, 65 percent of German respondents trust advice, which compares with 76 percent in Denmark, 75 percent in Austria, 60 percent in the Netherlands, and 79 percent in Finland, but only 22 percent in Greece.

17 For instance, in the United Kingdom, 91 percent of intermediary mortgage sales are "with advice" (*see* Financial Service Authority, *Mortgage Market Review*, Discussion Paper 09/3, (2009).

18 In a recent study, Hackethal *et al.* used trading as well as survey data from a sample of customers of a large German bank and found that over half of the surveyed customers stated that they consistently rely on the advice of their personal advisor. These customers are, predictably, less informed about financial products and do not perceive there to be a large conflict of interest—and they end up trading substantially more, thereby generating higher revenues for the bank, *see* A. Hackethal, R. Inderst & S. Meyer, *Trading on Financial Advice*, Mimeo, (2009). Georgarakos & Inderst find, using a pan-European survey, that trust in financial advice has a significant impact on the decision of less-educated households to buy stock or other risky and more information-sensitive "collective investment" products. Instead, for more educated households or those who do not perceive financial decisions to

be particularly complex, trust in financial advice does not significantly impact these decisions, *see* D. Georgarakos & R. Inderst, *Trust in Financial Advice*, Mimeo, (2010).

19 Incidentally, much empirical research that has access to detailed, micro-level portfolio and trading data comes from such online brokers, *e.g.*, T. Odean, *Do Investors Trade Too Much?* AMER. ECON. REV. 89, 1279-298, (1999).

20 For instance, for the United Kingdom the Thoresen Review in 2008 proposes to increase the level of "generic financial advice," so as to establish a minimum level of knowledge for all households that make financial decisions, *see* THORESEN REVIEW OF GENERIC FINANCIAL ADVICE, (2008).

21 Indeed, some studies have found that the provision of financial literacy education has only very limited and short-term effects, if at all (see the reviews in L. MANDELL, FINANCIAL LITERACY: ARE WE IMPROVING? (2004). The authors of a FSA report on financial capability thus conclude: "Making people better informed is hard and expensive and is of minimal value if it has no effect on behavior. This would be the case if low financial capability is more to do with psychological factors than lack of knowledge." Financial Service Authority, *A Review of Retail Distribution*, Discussion Paper 07/1, (2007).

22 For instance, Choi *et al.* show that such mistakes in the choice between index-tracking funds are common even among MBA students, *see* J. Choi, D. Laibson, & B. Madrian, *Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds*, NBER, (2006).

23 For pioneering work in economics on the tendency to favor the status quo, *see* W. Samuelson & R. Zeckhauser, *Status Quo Bias in Decision Making*. J. RISK AND UNCERTAINTY 1, 7-59, (1988).

24 To illustrate the consequences of procrastination, take a consumer who decides not to return a rented video today as the immediate disutility from walking to the shop exceeds the small charge for an additional day's rent. This decision may be fully rational for a consumer who expects the opportunity cost of returning the video to be higher tomorrow. But if the consumer naïvely underestimates the possibility of procrastinating again tomorrow, long and costly delay may be sustained. In economics, procrastination preferences go back at least to Strotz, and may account for low savings rates and the reluctance to participate in government or company sponsored savings plans. *See* R. Strotz, *Myopia and Inconsistency in Dynamic Utility Maximization*, REV. ECON. STUDIES 23, 165-80, (1956), and *also* T. O'Donoghue & M. Rabin, *Doing It Now or Later*, AMER. ECON. REV. 89, 103-24, (1999). Despite the foundations of procrastination in neuroscience (*e.g.* S. McClure, D. Laibson, G. Loewenstein, & J. Cohen, *Separate Neural Systems Value Immediate and Delayed Monetary Rewards*, SCIENCE 306, 503-07, (2004)), it is remarkable that countries such as Germany neither have a low savings rate nor high (revolving) consumer debt, which are empirical regularities that are commonly cited in support of procrastination.

25 For instance, in an interesting experiment, Fellner & Suttner show that subjects are willing to take on more risk when they receive less feedback on their investment choices and have to take a more long-term decision, (G. Fellner & M. Suttner, *Causes, Consequences and Cures of Myopic Loss Aversion—An Experimental Investigation*, ECON. J. 119, 900-16, (2009)). Similarly, such a tendency to avoid risky choices has also been linked to regret aversion, which makes people avoid situations where they appear to have made the wrong decision even when the decision was a priori correct (*e.g.*, G. Loomes & R. Sugden, *Regret Theory: An Alternative Theory of Rational Choice under Uncertainty*, ECON. J. 92, 805-24, (1982)). Generally, "mental accounting" refers to the cognitive method of treating different decisions in isolation, e.g., the decision to save for retirement and the decision to borrow for short-term consumption (*see*, R. Thaler, *Mental Accounting and Consumer Choice*, MARKETING SCIENCE 4, 199-214, (1990)).

26 A classic experiment in this vein was performed by Iyengar & Lepper, who showed that when the number of tasting booths for jam in a shop was increased from six to twenty-four flavors, then the fraction of customers who bought after tasting dropped from 20 percent to 3 percent, *see* S. Iyengar & M. Lepper, *When Choice is Demotivating: Can One Desire Too Much of a Good Thing?* J. PERSONALITY AND SOCIAL PSYCHOLOGY 76, 995-1006, (2000).

27 At least in some countries, when a customer pays directly for advice, the advisor is legally bound to pass on to the customer these benefits, implying that for the customer there is an immediate tradeoff. Also, the payments made to intermediaries may be funded by fees that are directly collected from the respective investment vehicles or that are funded from the additional interest ("yield spread") that a customer pays (*see* the discussion in H.E. Jackson & L. Burlingame, *Kickbacks and Compensation: The Case of Yield Spread Premiums*, STANFORD J. L., BUS. & FIN. 12, 289-361, (2007) and E. Keith, D. Bocian, & W. Li, *Steered Wrong: Brokers, Borrowers, and Subprime Loans*, Center for Responsible Lending, (2008).

28 Bolton *et al.* and Inderst & Ottaviani show this in a model of "cheap talk" applied to the financial industry, *see* P. Bolton, X. Freixas, & J. Shapiro, *Conflicts of Interest, Information Provision, and Competition in Banking*, J. FIN. ECON. 85, 297-330 (2007) and R. Inderst & M. Ottaviani, *Misselling through Agents*, AMER. ECON. REV. 99, 883-908, (2009). What mitigates this conflict of interest are reputational concerns as well as the threat of legal prosecution. In the analysis of intermediated investment management of Stoughton *et al.* a fund advisor charges an advisory fee based on the end-of-year value of the client's portfolio. According to a prevalent practice in the industry, investors are charged indirectly for advice through high loads that, in turn, give intermediary agents steep incentives to sell., *see* N. Stoughton, Y. Wu, & J. Zechner, *Intermediated Investment Management*, Mimeo, (2008). To this effect, it is indicative to note, in the United States, the low membership (of around one thousand professionals) in the National Association of Personal Financial Advisors (NAPFA), which admits only agents working on a fee-only compensation (*see* http//www.napfa.org). There are also legal obstacles, given that when receiving payment for advice, agents are subject to a stricter fiduciary duty. The U.K.'s financial services regulator has proposed plans to steer independent financial advisors fully toward direct charges for advice (Financial Services Authority, *supra* note 17).

29 *See also* the survey among EU members of the CFA Institute in which 64 percent of respondents agreed that the prevailing fee structure serves the purpose of steering sales rather than serving customers' needs, CFA Institute, *European Union Member Poll on Retail Investment Products: Summary Report*, (2009).

30 *See* Bergstresser *et al.* (*supra* note 14), R. Edelen, R. Evans & G. Kadelec, *What Do Soft Dollars Buy? Performance, Expense Shifting, Agency Costs*, Mimeo (2008), and J. CHEN, H. HONG & J. KUBIK, OUTSOURCING MUTUAL FUND MANAGEMENT: FIRM BOUNDARIES, INCENTIVES, AND PERFORMANCE, Mimeo ,(2006).

31 As noted previously, payments to brokers have reportedly led to distortions also in the U.S. mortgage market. Generally, such distortions are likely when commissions vary between different products and product groups. For instance, in the United Kingdom, the Financial Services Authority suggests that unsuitable advice in the prime mortgage market may be a lesser concern, because their fees are typically flat between different products.

32 As noted above, the evidence in Hackethal *et al.*, *supra* note 18, also suggests that customers differ in their perception.

33 *See* U. Malmendier & D. Shanthikumar, *Are Small Investors Naive About Incentives?* J. FIN. ECON. 85, 457-489, (2007) and H. Hong, J. Scheinkman, & W. Xiong, *Advisors and Asset Prices: A Model of the Origins of Bubbles*, J. FIN. ECON. 89, 268-287, (2008). Various theoretical attempts have been made to model the underlying bounded strategic rationality (*e.g.*, N. Kartik, M. Ottaviani & F. Squintani, *Credulity, Lies, and Costly Talk*, J. ECON. THEORY 134, 93-116, (2007)). In general, such boundedly rational individuals may not understand (even if they had the necessary information) what the actions of the various players imply for the resulting payoffs.

34 In Cain *et al.* subjects are paid for the precision of the estimates of the number of coins in a jar. They can rely on the additional judgment of an advisor, who can closely inspect the jar. In a first treatment, advisors are paid for the accuracy of the subjects' guesses of the number of coins; in a second treatment they are paid more when the guess is high. The estimate of the subjects is 28 percent higher in the second treatment, *see* D. Cain, G. Loewenstein, & D. Moore, *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, J. LEGAL STUDIES 34, 1-25, (2005). *See also* U. Gneezy,

Deception: The Role of Consequences, AMER. ECON. REV. 95, 384-394, (2005) on subjects' trust in advice.

35 This distinction between the provision of information, on the one hand, and making a recommendation, on the other, also underlies much of the applicable regulation (such as MiFID in Europe).

36 Inderst & Ottaviani distinguish between two types of unsuitable advice: advice on whether to purchase a particular product or not, and advice on which product to choose. Even when customers do not pay a direct fee and when commissions are high, there may be little bias in the choice between different products if the product providers compete for the agent's recommendation by offering counteracting commissions, *see* R. Inderst & M. Ottaviani, *Intermediary Commissions and Kickbacks*, Mimeo, (2008) and *supra* note 28.

37 This trade-off between a potential bias in the advisor's recommendation and the quality of the information gathered is analyzed in R. Inderst & M. Ottaviani, *How (Not) to Pay for Advice*, Mimeo, (2009).

38 Inderst & Ottaviani, *supra* note 28, explore this commitment feature of disclosed commissions.

39 See Inderst & Ottaviani, *supra* note 37.

40 For a discussion of disclosure with mortgage contracts, *see* J. Lacko & J. Pappalardo, *Improving Consumer Mortgage Disclosures: An Empirical Assessment of Current and Prototype Disclosure Forms*, Federal Trade Commission Bureau of Economics Staff Report, (2007).

41 In an experimental study, Cain *et al.*, *supra* note 34, find that advisors seem to be more prone to provide worse advice when the conflict of interest is disclosed.

42 In fact, the face-to-face situation may often be the factor that distinguishes advice from the provision of information at a distance, e.g., on the phone or through internet services. Furthermore, when advice is not customer-specific but regards general features of a product or service, such as quality or costs, issues may be similar to those arising with respect to deceptive marketing, e.g., through making false claims, denigrating rivals' products, or trying to pass off the product as another firm's.

43 OFT discusses various such techniques, building on Cialdini's "principles of influence." *See* Office of Fair Trading, *Psychology of Buying and Selling in the Home*, DOORSTEP SELLING REPORT, Annexe F, (2004) and R. B. CIALDINI, INFLUENCE: SCIENCE AND PRACTICE, (2001).

44 For details *see* Inderst & Ottaviani, *supra* notes 36 and 28.

45 As reported by the Financial Services Authority, *supra* note 21, this is the case in the Netherlands, Denmark, Finland, Sweden, Israel, and Australia, albeit to different degrees and not always through the imposition of formal requirements. Denmark and Finland have moved, according to this report, toward a full ban of initial commissions on life and pension sales through independent brokers, while the Netherlands has limited the initial commission on life-and-protection insurance contracts to 50 percent of the total compensation.

46 This discussion is based on Inderst & Ottaviani's theoretical analysis, *see* R. Inderst & M. Ottaviani, *Sales Talk, Cancellation Terms, and the Role of Consumer Protection*, Mimeo, (2008).

47 "Cooling-off rules" are used to target purchases that require an active marketing effort by sellers and for which buyers learn their utility only after purchase, as in the case of doorstep sales. These rules protect customers from purchasing under inflated perceptions. Interestingly, they typically apply less to situations in which there is no advice or face-to-face contact involved (with the exception of internet commerce). For instance, in the United State, the Federal Trade Commission requires sellers concluding transactions away from their premises to give buyers three days to cancel purchases of $25 or

more, with the exception of some goods (such as arts or crafts) or services that are subject to other regulation (such as insurance). In the EU, the "Doorstep Selling" Directive 85/577/EEC protects consumers who purchase goods or services during an unsolicited visit by a seller at their doorstep (or otherwise away from the seller's business premises). This regulation provides a cooling-off period of seven days, enabling the buyer to cancel the contract within that period and making the contract unenforceable if the buyer is not informed in writing of this right. Similar regulations are in place in most industrialized countries; *see supra* note 43, Annex E.

48 For instance, New York Insurance Department's Regulation 60 on "Replacement of Life Insurance Policies and Annuity Contracts" grants buyers an unconditional cancellation right for sixty days. Insurance Commissioners in many U.S. states have adopted a model regulation issued by the National Association of Insurance Commissioners that mandates an unconditional refund period of, typically, thirty days for life insurance and annuity replacements.

49 For instance, New York State Bill A8965 extends the duration of the mandatory "free-look" period (during which the insured may pull out of a purchased insurance contract and obtain a refund) from thirty to ninety days for individual accident and health insurance policies or contracts that cover an insured who is 65 years of age or older on the effective date of coverage. Similarly, the Omnibus Budget Reconciliation Act of 1990 mandates a thirty day free-look period to allow beneficiaries time to decide whether the Medigap plan they selected is appropriate.

50 As an example of self regulation, the Financial Industry Regulatory Authority (FINRA), the major self-regulatory organization for securities firms operating in the United States, mandates that broker-dealers make a reasonable effort to obtain information about the individual characteristics of their (non-institutional) customers and to ensure that their recommendations are "suitable" to customers' financial situation and needs. FINRA was formed in 2007 through a consolidation of the enforcement arm of the New York Stock Exchange, NYSE Regulation, Inc., and the National Association of Security Dealers (NASD). NASD Conduct Rule 2310(a) "Recommendation to Customers (Suitability)," originally adopted in 1939, prescribes: "In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." Added in 1991, Rule 2310(b) "Broker's Duty of Inquiry," further requires: "Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning: (1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives; and (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer." In addition, NASD Rule 3010 imposes a duty of supervision on the firm employing the broker-dealer. *See* R.H. Mundheim, *Professional Suitability of Broker-Dealers: The Suitability Doctrine*, DUKE L. REV. 3, 445-480 (1965) for an early account of the suitability doctrine and for a discussion of the evolution of NASD Rule 2310. For a more recent overview of the main legal issues relating to the enforcement of suitability regulation, *see* L. Lowenfels & A.R. Bromberg. *Suitability in Securities Transactions*, BUSINESS LAWYER 54, 1557-1597, (1999).

51 *See* Inderst & Ottaviani, *supra* note 28 for a detailed discussion.

52 For instance, especially outside the prime mortgage market, lenders rather than intermediaries may be held responsible for establishing an "affordability standard," even when they do not have direct contact with customers (*see* Financial Services Authority, *supra* note 17).

53 Carlin & Gervais present a formal analysis of the "team production" problem when both a product provider and an intermediary contribute towards making the supply of financial products suitable for consumers, *see* B. Carlin & S. Gervais, *Legal Protection in Retail Financial Markets*, Mimeo, (2008).

54 Selling without advice typically results in a loosening of regulatory requirements and of the liability risk for both intermediaries and product providers. For instance, in the United Kingdom only the buyers of advised mortgages have special rights of access to an Ombudsman.