



## Readability of financial advisor disclosures



Kyre Dane Lahtinen<sup>a</sup>, Stephan Shipe<sup>b,\*</sup>

<sup>a</sup> Mitchell College of Business, University of South Alabama, 5811 USA Drive South, Mobile, AL 36688, United States

<sup>b</sup> Peter T. Paul College of Business and Economics, University of New Hampshire, 10 Garrison Ave., Durham, NH 03824, United States

### ARTICLE INFO

#### JEL classification:

G20  
G28  
J33  
J44  
M14  
M52

#### Keywords:

Investment advisors  
Agency problems  
Textual analysis  
Readability

### ABSTRACT

We explore the readability of 30,000 registered investment advisor disclosures and find that these disclosures are written to a college reading level. This finding suggests it will be challenging for the average person to read a typical disclosure, which can lead to misunderstandings regarding conflicts of interest, fee structures, and the advisor's background. Moreover, there may be agency problems, and uninformed investors may also be deterred from seeking financial advice. The readability of these disclosures has decreased over the past seven years. These results are consistent among four different readability proxies and contradict SEC requirements for "plain English" language in disclosures, specifically for firms providing financial planning services to individuals.

© 2017 Elsevier B.V. All rights reserved.

### 1. Introduction

A Registered Investment Advisor's disclosure holds critical information about the advisory relationship including fee structures, conflicts of interest, and other behavioral expectations. Each client can read through this document before entering into an advisory agreement so that they understand these key elements. However, if this document is difficult to read, the potential client may avoid seeking investment advice, or, worse, enter into an agreement that they do not fully understand with an advisor that they do not know well. The purpose of this study is to determine the degree of readability of advisor disclosure statements and whether readability data aligns with the requirements set out by the Securities and Exchange Commission.

The disenfranchisement of uninformed investors is not a new topic and has been studied in the finance literature for some time. Notably, [Mehran and Stulz \(2007\)](#) and [Inderst and Ottaviani \(2009\)](#) show that agency problems from using investment advisors are more common with uninformed investors. Unfortunately, uninformed investors are the ones that need advice the most. [Campbell \(2006\)](#) explains that these uninformed investors are unable to correctly manage their finances on their own, placing them at greater risk of making mistakes.

Meanwhile, the decrease in the number of defined benefit pension plans and the increase in popularity of defined contribution retirement plans have placed investment choices and investment risk into the hands of individuals and not their employers. Accordingly, the role of investment advisors has become more complex to accommodate these changes. However, the growth in demand for advisors has led to the potential for agency problems. The need for clear investment advice has increased as the types of services and fee structures investment advisors provide have become more complex.

The importance of using plain English in financial documents has gained traction in recent legislation. To ensure that all parties understand what roles they play in the relationship, the State of Florida requires all insurance policies to be written with a minimum

\* Corresponding author.

E-mail address: [stephan.shipe@unh.edu](mailto:stephan.shipe@unh.edu) (S. Shipe).

Flesch Reading Ease score of 45. This score is equivalent to needing some college education to understand the policy. This requirement implies that the majority of documents should be written at a high school level or lower.<sup>1</sup> For similar financial decisions, such as a client relinquishing financial responsibilities to an advisor, there is a notable absence of research on the readability or enforcement of readability of financial advisor disclosures.

While it is easy to explain how difficult to read disclosures affect clients, it is equally important to understand why this potential problem exists. One explanation appears related to practicality. Writing in plain English can be challenging for many people; so, to assist, the SEC has provided a guide to writing in plain English (Commission and Exchange, 1998). This document is very useful and provides advice for effective writing. However, the writing guide does not give clear criteria for writers to know whether their text has achieved plain English status. The guide suggests focus groups may be the only appropriate methodology for testing the readability of a document. While focus groups may be effective, they are not practical for most advisory firms that provide services to many different types of clients. Firms are legally obligated to produce one disclosure brochure, therefore, it is possible that this brochure may not achieve the readability requirements for all potential clients.

In this paper, we examine new data of Form ADV disclosures by using traditional tests of readability. Using textual analysis of 30,000 Registered Investment Advisors' Form ADV Part II Brochures (filed with the SEC), we find that these disclosures are typically written at a college level or higher. This is a significant departure from the SEC's requirement that an advisor's brochure must be written in plain English so that the target clients can understand the qualifications and role of the advisor in their relationship. Due to the readability barrier to entry, uninformed clients are put at a disadvantage and are more likely to miss important items disclosed in the Form ADV brochure.

Along with our finding that the average brochure is difficult to read for most of the population, the difficulty in readability has also increased over the seven-year window under study. Further, we identify which types of firms have the most difficult to read disclosures by dividing our sample by the services a firm provides. Our findings suggest that, as the number of services a firm provides increases, the reading difficulty also increases. The relationship between the number of services and reading difficulty is likely due to the restriction on advisors of providing only one disclosure to all types of clients

Choosing a financial advisor is an important decision and can have lasting effects on the financial health of the client. In a time when financial products and services have grown in their complexity, it is even more important that the advisor relationship is explained in simple terms so both the client and the advisor understand their roles, the fees associated with the services, and any conflicts of interest that may exist. However, to date, no analysis has been performed to assess the readability of disclosures.

The rest of the paper is organized as follows: Section 2 describes the data and methods used in the analysis. Section 3 reports the empirical results and discussion of the analysis. Section 4 concludes by summarizing the contributions of the paper and providing suggestions for how this problem could be remedied from the standpoint of both regulation and service delivery.

## 2. Data and methodology

Data for the analyses come from the Uniform Application for Investment Advisor Information (Form ADV). Section 204 of the Investment Advisers Act of 1940 requires investment advisors to provide certain disclosures to all clients; Form ADV is the mechanism used to collect this information. Form ADV is divided into two parts; Part I contains a series of direct questions advisors must answer related to their firm and clients, and Part II is satisfied by filing a written advisor brochure and brochure supplements containing more detailed information about the firm. Part II of the Form ADV, or the brochure, holds important information including conflicts of interest, fee structures, the role of the advisor, advisor backgrounds, and services provided. For the client, the importance of understanding what is contained in the advisor brochure cannot be overstated.

Our initial data span a period from 24 April 2007 to 14 March 2015 and includes 104,935 filings. The filings contain certain issues that need to be corrected. For example, many firms file nearly identical copies of the same brochure on the same day. To account for this, we take the average of our readability measures for all filings by an advisory for any given day. We recognize that taking the average of the measures treats all filings equally, regardless of brochure length or type. Averaging also could result in the loss of information from brochures that should be considered individually. However, we believe the trade-offs between taking the average and these drawbacks are reasonable. Averaging the results over the daily window reduces our sample size to 85,887 observations. We merge the Part I data to the Part II filing that most immediately preceded it, leaving 35,186 observations. We Winsorize our data at the 1% and 99% levels by moving extreme upper and lower tail values to the percentiles mentioned. Winsorizing reduces the effect of outliers on our final results. Table 1 contains descriptive statistics of our data.

Form ADV Part II must follow certain requirements outlined in Commission and Exchange (2011), for the purposes of this work we will focus on the requirement that the brochures must be written in "plain English". The SEC states that to achieve "plain English" writers should "(i) use short sentences; (ii) use definite, concrete, everyday words; (iii) use active voice; (iv) use tables or bullet lists for complex material, whenever possible; (v) avoid legal jargon or highly technical business terms unless you explain them or you believe that your clients will understand them; and (vi) avoid multiple negatives".

Researchers have established several methodologies to identify the difficulty of reading and understanding a document. We use three different readability metrics that are common in the finance and accounting literature to analyze these advisor brochures. Recently, these techniques have been used to rank the readability of annual reports, management discussion, chat rooms, or other public disclosures (Li, 2008). However, no studies have measured the readability of investment advisor disclosures. In addition to the common readability metrics, we follow Loughran and McDonald (2014) and use file size as an additional proxy for readability.

<sup>1</sup> §627.4145, Fla. Statute (2016)

متن کامل مقاله

دریافت فوری ←

**ISI**Articles

مرجع مقالات تخصصی ایران

- ✓ امکان دانلود نسخه تمام متن مقالات انگلیسی
- ✓ امکان دانلود نسخه ترجمه شده مقالات
- ✓ پذیرش سفارش ترجمه تخصصی
- ✓ امکان جستجو در آرشیو جامعی از صدها موضوع و هزاران مقاله
- ✓ امکان دانلود رایگان ۲ صفحه اول هر مقاله
- ✓ امکان پرداخت اینترنتی با کلیه کارت های عضو شتاب
- ✓ دانلود فوری مقاله پس از پرداخت آنلاین
- ✓ پشتیبانی کامل خرید با بهره مندی از سیستم هوشمند رهگیری سفارشات