

Disclosure of Conflicts of Interest

John Sullivan
CFP™, ChFC, CLU, AIF™, MBA
World Equity Group
Arlington Heights, Illinois

If the “fiduciary standard” were to be applied to brokers and insurance agents, they would be required to “put the clients’ interests first” and “disclose conflicts of interest”. This article will focus on particular conflicts of interest that might have to be disclosed if, indeed, “disclosure” should come to pass. Opinions expressed in this article are not necessarily anyone’s but mine and are meant to be a small addition to the ongoing discussion on this subject.

However, any discussion of conflicts of interest in wirehouses and insurance companies *must* begin with a clarification of the two types of disclosure involved. First, there is the matter of the disclosure between the broker or agent and the client. Second, there is the matter of the disclosure between the firm and its brokers or agents. *If the firm does not disclose material conflicts to its employees, how can the brokers and agents disclose them to their clients?*

As an example, let us say that Glom Brothers has bonds in its proprietary portfolio that it feels will be downgraded. They decide that these would be excellent purchases for their Glom Bond Fund. Does anyone seriously believe that Glom Brothers will tell their brokers that they are dumping undesirable securities in the fund that they want them to sell to their clients? I put it to the reader that the conflicts of interest that are not disclosed to brokers and agents by their own firms are of much greater importance than those that are not disclosed by brokers and agents to their clients.

Please keep in mind these *two* types of breaches of trust as we look at the following:

1. Proprietary mutual funds. This issue has been thoroughly discussed and a recap would include conflicts re the “stickiness” (funds that can not be transferred) of proprietary funds, differences in compensation or “favor”, the possibility of abuse in the area of “security dumping” within the funds, high expenses that may include high trading fees to the firm that owns the fund, etc.

As an extreme example, Glom dumps undesirable securities and securities of its investment banking clients into the Glom Fund. This is not disclosed to its brokers. After all, the so-called “Chinese Wall” is supposed to prevent retail brokers from knowing who their “investment banking” clients are. The brokers know that this fund cannot be transferred out of Glom and do not disclose this to clients, lest the clients choose other funds that are not “sticky”. The Glom Fund

does its trading through Glom Brothers at a high price, which is passed on to clients in high expense ratios. This is not disclosed to Glom brokers. The Glom Fund pays Glom for research at a high price which is passed on to clients of the Glom Fund, again unknown to the Glom brokers. One thing the Glom brokers *do* know is that brokers that do not use Glom Funds tend not to be around very long.

All of these conflicts should be disclosed first to the broker or agent and then to the client.

2. Proprietary annuities. These include most of the potential for abuse that proprietary funds do, particularly since they often include proprietary funds. An additional conflict of interest is that these annuities may pay the broker more than “outside annuities”. There is also the possibility that there are “soft dollars” kicked back to Glom Brothers from the non-proprietary funds that wish to be included in the fund lineup. Trading through Glom might be “encouraged”.

All of these conflicts should be disclosed to the broker or agent and then to the client.

3. Funds or other investments from which the firm derives a financial benefit. For example, Glom Brothers owns 50% of Molg Funds. It is in their interest to “push” Molg Funds and it is not in their interest to advise their brokers of this fact. Molg Funds may purchase “investment banking” securities from Glom. Molg Funds may do their trading through Glom and buy “research” from Glom. Molg may pay Glom “soft dollars” to Glom “just because they like them so much”. Finally, if Molg Funds do well, does not Glom, a 50% owner, financially benefit?

All of these conflicts of interest should be disclosed to the broker and then to the client.

4. Investment banking clients. These *must* be disclosed to the broker or agent. This conflict of interest is enormous and has been a source of abuse in the past to the tune of tens of millions of dollars in fines. If this disclosure cannot be made, then investment banking and retail brokerage should not be allowed in the same firm. This should probably be banned anyway because typically the same market analysts serve both investment banking and retail brokers.

Any involvement of investment banking clients with retail clients should be disclosed to the broker and then to the retail client.

5. Proprietary research. Let’s say that every week, brokers receive research that recommends certain stocks and has a low rating on other stocks in each sector of the market. Clients are unaware of the nature of these recommendations as to whether they are owned by Glom Brothers or not – nor are the brokers. They are

also unaware that these recommendations may be, by independent research, “neutral to neutral”. What could this accomplish? For one thing, unnecessary trading commissions.

Brokers should be advised by their firm that these “sell-buy” recommendations are nothing but revenue generators in the opinion of independent research so that the brokers might similarly advise their clients. The client should always be made aware of the positions Glom holds in order that he might judge for himself what influence that might have on the recommendations it makes. However, this cannot happen unless the broker or agent knows.

6. Principal trading. Principal trading is not necessarily “security dumping”. Principal trading may be of great benefit to clients. I will leave it to the reader to conclude whose interests Wall Street will put first. “Security dumping” is illegal but I cannot recall a single case of accusation of such. Perhaps the Wall Street “honor system” is working. This, however, does not mean that security-dumping does not - or could not - occur. We would never know if it occurred because it is impossible to detect. After all, who knows why a wirehouse chooses to sell a particular security to a client?

Since “security dumping” - should it occur - is a virtually “risk-free” activity, this conflict of interest should be disclosed with unmistakable clarity. Surely, clients should be made aware that a security that is being recommended is being sold to them from the Glom Brothers portfolio. Surely, they can then ask themselves why, if the security is so good, Glom Brothers wants to sell it. Glom should not be able to “trade against” their retail clients without disclosure.

7. Differences in compensation. A broker or agent may have two similar Variable Annuity options from the same insurance company. One, the “Gleaner”, has a 7-year surrender period, good funds, low expenses and pays the agent a 7% commission. The other, the “Gatherer”, has a 10-year surrender period, higher expenses, lesser funds, and pays the agent a 10% commission. Since the difference in compensation can come from nowhere else other than the client’s return, should not the broker or agent disclose this conflict of interest? Is this what they mean when they say that regulation would restrict customer choices? If the “Gatherer” were regulated away, would the client suffer from the loss or would Glom Brothers suffer? Could it be that “reduction of choice” would really mean that Glom Brothers would have a “reduction of choice” to sell the most profitable option without mentioning the option that is best for the client?

No, in fairness to the client, both options should be presented and the difference in compensation for Glom and the Glom broker should be disclosed.

8. Limits on choices. The client should always be aware of the range of products that are available to the broker or agent that is proposing them. Is the product

recommended chosen from a vast array of similar products or is it the only one available to the broker or agent? Does the Glom broker recommend the Gleaner annuity because it is the best for the client of the many available, or does he recommend it because it is the only one Glom allows him to sell? Does the insurance agent recommend an index annuity for good reason, or because he is not licensed to sell what even *he* may feel are better alternatives?

The client should have the necessary information disclosed to him so he may judge for himself.

9. Fear. This can be a very real conflict of interest. Glom Brothers periodically lays off their “least productive” brokers. What is a “less productive” broker? It is the broker that gets the least percentage out of their clients.

Should not the broker or agent disclose that he works for a firm that will fire him if he does not achieve a certain percentage of assets in revenue for the firm? After all, the more the firm gets, the less the client gets. This seems like a *huge* conflict of interest.

10. Reciprocity agreements. This can be an issue with both brokers and insurance agents. The tax preparer notices no IRA deduction and recommends a broker. A divorce attorney sees no life insurance and recommends an agent. A bank teller sees a large CD come due and recommends the bank financial advisor. A real estate agent recommends a particular mortgage broker. All of these situations can be good for the client, but should he not know that the “recommendor” is getting paid by the “recommendee”?

Reciprocity agreements are conflicts of interest that should always be disclosed. Is the “Golden Rule” suspended in financial services?

11. Retirement plans. These present a host of conflicts of interest, most of which are outlined above. However, there is an additional conflict of interest that is particular to the selling of 401k and 403b plans. This is the opportunity to abuse the trust of the plan sponsor by using the plan to solicit clients for the plan provider. Glom provides a 401k plan “for free”. They are going to make money on the funds, etc, as they do with other clients. They are also banking on picking up assets from plan members on rollovers and in-service distributions. Notice how they offer to take over the paperwork burden from H.R. personnel as a “service”. Notice how the rollover paperwork has “Glom Brothers” all over it. If the retiring employee wants to roll over his 401k to a Glom IRA, he may do so with a simple signature. If he wants to roll over his 401k to anyone else, he must call Glom Brothers where he will be diverted to a salesman charged with getting the employee to use Glom Brothers instead. That employee receives

compensation for all the assets he keeps at Glom Brothers. Gee, could that be a conflict of interest?

401k plan providers should disclose, as a conflict of interest, if they plan to use the sponsor's employees as a prospect pool and use the plan for that purpose. This is only fair to the plan sponsor and his employees.

12. Titles and designations. I believe that it is a blatant conflict of interest to use a title that has little or no meaning. Should not the investor know, so that he may judge for himself, exactly what the broker or agent actually is? If a janitor calls himself a "Sanitation Engineer", there is no harm – everyone sees the broom. However, deceptions of this sort in financial services can have dire consequences for the consumer. Hypothetical disclosures of conflicts of interest could be as follows:

- "My card says "Financial Adviser". In my case, this means that I have a license to sell securities. I am not a fiduciary. I am a salesman for Glom Brothers"

- "My card says "Financial Adviser" . In my case, this means that I have a license to sell securities, I am licensed to sell life insurance, and I have a series 65 which allows me to have Advisory Accounts. However, I am not a fiduciary. I am a salesman for Glom Brothers."

- "My card says "Financial Planner". In my case, this means that I sell insurance products that may be financial planning tools."

- "My card says "Vice President of Investments". In my case, this means that I have a license to sell securities for Glom Brothers"

- "My card says "Wealth Manager". In my case, this means that I have a license to sell securities for Glom Brothers."

- "My card says "Certified Oldster Financial Caretaker". In my case, this means that I am the type of element your community tries to keep under control."

- "My card indicates that we are a "Financial Planning" firm. However, in our case, we are a brokerage arm of an insurance company and we are required to sell a quota of proprietary insurance in order to work here as "financial planners" or some such."

It is curious that the consumer only wants to be treated with the same fairness that anyone would expect in a club member, a hardware store salesman, a golf partner, spouse, friend,

or in any other human relationship. All the client wants is to receive all the material facts that he should have to make a good decision. Why is this so hard to come by in financial services?

The client provides all of the capital and takes all the risk. In return he gets very little. The average investor doesn't even beat inflation while financial firms "do quite well, thank you" - even after they distribute huge bonuses to top management. Wouldn't a fairer split be in order? Should we keep the scales tipped in favor of a thousand retirements for the CEO of Glom Brothers while those who provide the capital get none? Why such a fight over "Fiduciary Duty"? What do "conflicts of interest" accomplish? The answer, in my opinion, is chillingly simple:

Fiduciary Duty means disclosure of conflicts of interest.
Disclosure of conflicts of interest means fewer "conflicted products" sold.
Fewer "conflicted products" sold mean less revenue for the seller and more for the buyer.
"Fiduciary Duty" means "Less Revenue".

Can there be any doubt that issues that engender "conflicts of interest" exist in the first place for the sole reason of *gaining a bigger piece of the investment pie for the seller and thus leaving less for the buyer?*

This article is for purposes of information and discussion only. It is not an offer of services or a solicitation of business.