

Principal Trading

Max has a bad egg – no doubt about it. When he walked into his diner before dawn this morning and snapped on the lights, he saw that an egg had been left out in the 100 degree heat for an entire night and perhaps longer. From years of experience he knows that if he taps the egg in a certain way, he will be able to tell by its sound if the egg is bad. Oops! That is one *bad* egg! He cursed his error and weighed his options regarding the disposition of the egg.

Now, Max is not a bad guy. He feeds stray animals behind his diner, he treats people in a friendly manner, he attends their weddings, and he likes children. However, when it comes to money out of his pocket, he has an unfortunate Narcissistic “sense of entitlement”. In other words, he doesn’t feel that he should have to take the consequences of his actions (unless they are good ones).

In addition to running his diner, Max sells eggs to other eateries and considers Joe’s Diner across the street as a possible outlet for his bad egg. He remembers, however, that Joe knows eggs as well as he does and he would probably not get away with it. Max has another idea. It seems that he sells 5 pounds of scrambled eggs every day to the local golf course who offers the eggs to their early morning golfers as a courtesy. Perhaps the bad egg would not be noticed in the mix. Max decides not to take this route because of the risk. If those “damned golfers” complain, Max may lose the account to Joe’s Diner.

That leaves his retail customers. Max plots. He could hard-boil the egg and he may get away with it. He could put the egg in his mix for scrambled eggs. He could put the egg in an omelet. He could put the egg in his French toast mixture. He could use the egg in one of his pies or cakes. He could put the egg in his Quiche mixture. He could fry the egg and put it on a plate under the hash browns. He could put in his egg salad. He could even split it up and put it in several different places. “Come ‘hell or high water’, he is not going to take the loss of that egg himself! Why should he? He is smarter than those farmers and truck drivers! If they think that he is required to do his best for them and disclose his conflict of interests, that’s their problem! Thank goodness he isn’t a ‘Certified Short-Order Preparer’!”

Max’s elation suddenly dims. He was forgetting one thing – his loud, bleached-blond, heart-of-gold, always smiling, energetic and bright waitress who stood between him and his customers. She was christened “Belinda”, but everyone calls her “Billy”. Should he trust her with his plan? No, she has these sudden and frequent displays of honesty. Also, Max has noticed that she is very friendly with the customers and they seem to think the world of her. Once, when Max noted how much money she made delivering food to the tables, Billy told him that she didn’t just “deliver food” - she was really “in the relationship business”. She said that she cared about her customers on a personal level, that they had gotten to be her friends, and she even protects their stomachs when Max cooks up something “pea-pickin’ vile”.

“No”, Max thinks, “better not tell *that* one a thing. Instead, I will keep her in the dark and feed her manure.” Max chortles at the image of “Mushroom Billy”. Max also reasons that one way of increasing his chances of getting Billy to get rid of the bad egg is to have a “special” on eggs. She will think that she is doing her customers a favor by “pushing” the egg dishes. He will use her virtue against herself. Only later, when a customer gets sick, will she realize that Max “snookered” her. She may even give him the benefit of the doubt and chalk it up to an honest mistake on Max’s part. Max will be happy to admit that he “erred” and will even look contrite.

Knowing Max’ culinary limitations, Billy is always on the lookout for bad products from the kitchen. However, Max figures that she will be less likely to discover the bad egg if he disguises it in some way. He may just put the egg in one of the mixtures already mentioned. That way, more customers will get sick, but no *one* of them will get *that* sick. Surely, most of them will not sick enough to take their business elsewhere.

“Just a minute!” , thinks Max, “Billy’s reputation will keep the customers here - at least for as long as it lasts. She brags about her “relationships”! Let’s see how many bad eggs its worth. I can even buy *more* bad eggs and *really* make some money in this dump. When the customers start to complain to me, I will use that practiced sigh, slowly shake my head, mumble something about ‘a few bad waitresses’ , and hire someone else who has more concern for my customers. Poor me!”

Max can also count of the fact that he is an “experienced egg man” and his customers “wouldn’t know an egg if it fell on their heads”. He can always give them some song and dance about “magnetic fields”. Besides, it says on the back of the menu, “Maxum ova nolo ixnay impeccable paradigms pursuant to ABCD regulation b42(f) and above chattel avocado sec.122(b) *res Vasquez* estoppel gobbledygook”. They were informed! In writing!

“Wait”, Max thinks, “Billy is not my *only* waitress. Bernadette, referred to by one and all as ‘Dumbo’, might also be the unwitting dupe in this business. My chance of Billy ‘Smarty Pants’ getting this egg is only 50%!” This makes the dumping of this unwanted egg too good to pass up and Max holds his nose, cracks open the egg, and drops it in the scrambled egg bowl.

Now, how can an investment firm that engages in “principal trading” dump an unwanted security on its retail customers?

1. Their research analyst can put a high rating and/or a high price target on it and let the broker do the rest. The “Chinese Wall”? Spare me!
2. They can put it in their “Company Model Portfolio” and let the brokers draw their own conclusions and make their own recommendations. “After all, if it is in the ‘Model Portfolio’, it surely must be good.”
3. They can put it in a prepackaged equity portfolio that is sold “as a whole”.

4. They can offer it to the managers of their proprietary funds. Who can say why they buy it?
5. They can offer it to their proprietary “Separate Account” managers. Who can say why they buy it?
6. They can put it in a proprietary Unit Investment Trust.
7. They can propose stock swaps where their proprietary research rates one stock as an “underperform”, its replacement as an “outperform”, and let the broker do the rest.
8. They can propose bond swaps where an unwanted bond is made more attractive than an existing bond in a client portfolio and let the broker do the rest.
9. They can put an unwanted bond in a prepackaged bond ladder.
10. They can put an unwanted bond in a custom bond ladder.
11. They can put an unwanted bond in a “monthly income” package of bonds.
12. Proprietary annuities may use proprietary funds that contain unwanted securities.
13. They can put unwanted securities or “funds with unwanted securities” in “Asset Allocation” funds or special funds used in 401k plans.
14. Who knows what arrangements might exist between firms? Is it possible that one firm might say, “You take our junk and put it in your funds and we’ll take an equal amount of your junk and put it in our funds”?

It is so hard to hope for the best from a “Wall Street Firm” when they historically have been so.... *guilty*. They pay multi-million dollar fines (a second’s income shot to hell!), quite Narcissistically declare that they are paying the fine “without admitting any wrongdoing”, and go about their business. It is also hard to hope for the best from the regulating agencies in this industry because they historically have been so.... *drowsy*.

I can’t, quite honestly, see how a CFP™ Certificant can work for one of these firms and remain true to the new CFP™ Code of Ethics. There are just so many inherent conflicts of interest that one would spend all of one’s time disclosing them. Why work for a firm like this when they can work for an “Independent” that has none of these conflicts? On the other hand, these firms cannot possibly want these conflicts of interest disclosed because disclosure will reduce their income. Therefore, I conclude that they will tend not to continue to encourage their people to become CFP™ Practitioners or, possibly, they just won’t “get it” and have to learn the hard way that “putting the client first and disclosing all conflicts of interest” just doesn’t fit their business model.

This world would be a great improvement: some firms sell securities and “let the buyer beware” - others do financial planning, put the clients’ interests first, and have no conflicts of interest. How much better this would be than these firms posing as “Financial Advisers” in order to sell products and still “let the buyer beware”!

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