**An Alternative to the Fiduciary Standard of Care**

John Sullivan
Palatine, Illinois

Most investors receive a "suitability standard of care" and, over the past 20 years, have received an average of less than 2% return on their investments. They do not even beat inflation. During the same period, the firms that they invest through have realized a 10-20% rate of return. Now, investing is a "Zero-Sum" game – there is only so much that can be made on capital at any given risk level. Investors provide 100% of the capital and take 100% of the risk. One would think that they should get a bigger slice of the pie.

Anyone doubting the above should consider two facts. First, Financial Advisers at Wall Street firms receive nothing but "sales training" and no "investment training". They are to gather assets that the firm can make money on. Second, Financial Advisers are weeded out on one basis – "What percentage of the clients' return on their assets is retained by the firm?" If a Financial Adviser is doing well for the client and, consequently, poorly for his firm, he is a "less productive" broker and soon gone.

A "Fiduciary Standard of Care" requires two basic elements. First, act in the *sole* interest of the client and get compensated on that basis. Second, disclose any "conflicts of interest". On the second point, the financial adviser must disclose any known conflicts of interest to the client. However, most conflicts of interest are not disclosed to the financial adviser by his own firm. Therefore, before the financial adviser can disclose these conflicts to his client, the firm must first disclose conflicts to the financial adviser. *This,* these firms *will not do.*

Why? Because they know that "disclosure of conflicts of interest" = "less revenue". When consumers are told material facts that are not to their advantage, they usually do not buy the product. Disclosure of conflicts of interest would put these firms out of the retail investing business in a month.

Explanation of the "suitability standard of care" would have an even harsher effect. They would have to disclose the following.

- there is no duty of "due diligence" – almost any investment is "suitable"
- there is no duty to monitor investments
- there is no duty to disclose conflicts of interest
- they may take positions against clients
- there is no duty to correct client misperceptions
- they are allowed to "outsmart" their clients in trades
- they may profit from "superior knowledge" relative to their clients at the expense of their clients

What can be done to help level the playing field so maybe investors can get some of that obscene Wall Street money? The following are some items that put the individual investor at a disadvantage.

- <u>the prospectus</u> The prospectus was originally designed to protect consumers. Now, it is boilerplate written by lawyers that is meant to protect insurance companies from unwelcome intrusion by consumers into the details of the contract. Risks, including "inflation risk" should be in bold type on the front page as well as any stipulation that is

to the detriment of the investor. It was a big mistake to let the issuer write the prospectus. It might be well to have the prospectus written by an outside party.
- investment banking  Abuses related to the interaction of investment banking business and retail investors are multifold. Promoting the securities of investment banking clients and tainting research in favor of investment banking clients has been documented in the past and no one thinks Wall Street firms have sprouted wings and flown off to "goodieland". The only real way to curb abuses is to forbid retail investing business and investment banking business in the same firm. Spin them off.
- proprietary trading  No retail investor understands the difference between an "agency trade" and a "principal trade". If they did, they would ask themselves the questions, "If this stock/bond is so good, why does the firm want to sell it out of their portfolio to me? Why don't they want to keep it for themselves?" It is not fair to let one of the top bond traders in the world compete with his retail client who, polls show, is "financially illiterate".
"Security dumping" is against the law, but it is a "risk-free" activity. No one can prove what is in the bond manager's mind when he offers a bond to millions of retail clients through thousands of brokers. We can be sure, however, that if he wants to get rid of the bonds, he is not going to disclose to the brokers that he thinks(or knows) that the bonds are going to be downgraded and their clients will lose 25%. How many GM, Ford, and GMAC bonds were unloaded on retail clients 8 years ago just before they were downgraded to "junk". Were there any repercussions? Who can say what the bond managers thought?
This is another area where the investment firms simply must be separated from retail clients. No firm should be allowed to have a proprietary trading business and also a retail investing business. Spin them off and let them pick on someone their own size.
- Complex products  Complex products are "complex" for a reason – they pay better because retail investors don't understand them and can be fooled. Abusive financial products should be subject to recall just as cars, toys, and peanut butter. Since financial firms would not be able to function with such a sword hanging over them, they would have to buy "recall insurance" just as automakers do. The more abusive the product is, the higher the risk of recall, and the higher the insurance premiums. The free market will limit abuse. Currently, insurance companies manufacture products that are easy to abuse, sell them through independent agents, and wash their hands of any actual abuses.
- Ratings agencies  The conflict of interest presented by being paid by the firm issuing the securities must be addressed.
- Designations  Polls show, over and over, that consumers do not understand these. The terms, "Financial Planner", "Financial Advisor", "Wealth Manager", etc should be regulated or not used without a disclaimer, eg, " I am a Certified Senior Advisor, which means I spent a weekend in Florida and passed an open-book test".

What is an alternative to a "Fiduciary Standard of Care" that would give consumers a fair shake? Retail Client business must be spun off from Investment Banking. Retail Client business must be spun off from any Proprietary Trading. A "Clearinghouse Industry" must be established as a dealer in financial products that they buy from manufacturers and sell to consumers. Ratings on the products are paid by the "buy side". The free market will stop the abuse of retail clients by manufacturers. The Clearinghouse is knowledgeable where clients are not. The Clearinghouse can select the best products available from any manufacturer and competes with other Clearinghouses. They will rate the products and build it into their price. They will do truly independent research on the products and prosper or not according to their ability. The investing public will triple their return on their savings. Oops! Wall Street will have to work more and make less. They will have to manufacture products that they will have to sell to someone their own size and have to compete with other manufacturers to do so. They will not have a captive market. On the buy side, financial advisers will be able to choose from any available product on terms that are set by the market – not by the manufacturer. They will be able to do their best for their clients without fear of being canned for not selling enough of a proprietary product or a product that pays the manufacturer the most. Enough of the Wall Street "Honor System"!