James J. Angel, Ph.D., CFA
Associate Professor of Finance
Georgetown University
McDonough School of Business
Washington DC 20057
angelj@georgetown.edu
1 (202) 687-3765

October 24, 2010

Securities and Exchange Commission
100 F St. NW
Washington, DC 20549-9303
Rule-comments@sec.gov

File Number 4-606
Study Regarding Obligations of Brokers, Dealers, and Investment Advisers

Dear Securities and Exchange Commission:

The issue of the appropriate ethical obligation of a broker or investment advisor to a client is a very interesting and important one.[1] One of the complexities is that modern financial service firms often operate in different roles with respect to their clients at different times. Brokers provide many services, and there are times when it is appropriate for different standards to apply. There is no one-size-fits all standard that applies to all broker/dealer/advisor interactions.

Clients -- especially retail clients – are often confused as to the exact role their broker/advisor is playing. Unfortunately, consumers don't know what they don't know, and many are confused by the plethora of different advice providers who use a variety of similar sounding titles.

The important things is that there should be a clear meeting of the minds between the customer and the broker/dealer/advisor of exactly what the relationship is between them for each transaction. There should be no confusion among consumers as to what they are paying for.

[1] Note that I am using the spelling advis<u>o</u>r instead of advis<u>e</u>r to reflect the large number of advice givers regardless of whether they are Registered Investment Advisers (RIAs) or not.

It seems reasonable that the nature of the obligation should be a function of the product that the consumer is buying. Sometimes they are buying advice, sometimes a specific transaction, and sometimes a different service. For example:

- If the product sold is that of advice, then the appropriate standard should be that of a fiduciary and that advice should be in the best interest of the client. Anything else is fraud, because the seller is delivering a service different from what the consumer thinks he or she is buying. It should not matter whether the advice sellers call themselves brokers, advisors, planners, wealth managers, or financial consultants.
- If the product sold is that of executing a trade specified by the client, then the appropriate standard is an agency standard. The agent should work to achieve the best execution of the trade.
- If the product sold is a limited mandate such as managing a mutual fund relative to a given benchmark, then the obligation is to perform that mandate with appropriate care.
- If the product sold is an arms-length proprietary transaction, then the only obligation is to settle the transaction on the agreed upon terms.

I recommend that the nature of the relationship should be clearly disclosed to the client and clearly repeated in standardized plain language (not obscure codes) in readably large print (14 point or larger) on every confirmation.

For example:

> Our relationship with you for this transaction is that of an **advisor**. Our duty is to provide advice that we believe is in your best interest and to act in your best interest when implementing the advice.

> Our relationship with you for this transaction is that of an **agent**. Our responsibility to you is to execute your instructions as best as we can. We take no position on whether your instructions are right for you or not.

> Our relationship with you for this transaction is that of a **fund manager**. Our responsibility is to manage the portfolio in accordance with its investment guidelines. We take no position on whether these investment guidelines are right for you or not.

Our relationship with you for this transaction is that of a **principal**. We are taking the other side of the trade and our interests are the opposite of yours. We make no representation whatsoever that this transaction is right for you or that the price is better than what you could have obtained elsewhere.

Sometimes, there are mixed relationships, in which case the higher standard should usually prevail. For example, many brokerage firms execute retail customer orders internally by filling them from their own inventory. This can be faster and more efficient because fewer parties are involved in the transaction. However, if the client is paying the broker to get best execution, the broker has a duty to provide that even when trading on a proprietary basis, and this duty should be clearly stated on the confirm.

Attached is a paper that Douglas McCabe and I have written on this topic, which is closely related to the required study. It is also available for download at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1686756.

Respectfully submitted,

James J. Angel, Ph.D, CFA
Georgetown University
McDonough School of Business
Washington DC 20057
(202) 687-3765
angelj@georgetown.edu

Ethical Standards for Stockbrokers:
Fiduciary or Suitability?

by

James J. Angel, Ph.D., CFA
and
Douglas McCabe Ph.D.
McDonough School of Business
WashingtonDC20057USA

angelj@georgetown.edu
mccabed@georgetown.edu

Draft 1.05
September 30, 2010

Ethical Standards for Stockbrokers:
Fiduciary or Suitability?

Abstract

What are the ethical obligations of the sellers of financial products to their customers? Stockbrokers in the U.S. have a legal and ethical requirement to recommend only "suitable" investments to their customers. This is a fairly weak standard. Currently, there are proposals to raise the standard to a fiduciary one in which the recommendations would have to be in the best interests of the clients.

Brokers sell solutions to financial problems. Similar to an auto mechanic or a doctor, the product often consists of both the professional advice and its implementation. There are numerous conflicts of interest between brokerage firms and their customers in that the products that pay the highest commissions may not be the best one for the customers.

The societal perspective adds complications, however. Society depends on modern financial markets to raise capital for productive enterprises and to spread risk. Issuers of financial products need distribution channels for their products just like the producers of any other products. Commissions create powerful incentives for the distribution channels, but at the same time produce conflicts of interest – a type of ethical pollution. Just as our society tolerates some pollution as a byproduct of other useful activities, it may be useful to tolerate some of these financial conflicts of interest.

The nature of the relationship should govern the ethical standard. Those selling advice, regardless of how they label themselves, should adhere to a best interest fiduciary standard. More limited relationships would be limited to the mandate involved in the relationship.

Introduction

The ethical obligations of the sellers of financial products are currently a matter of intense public debate and lobbying. This issue raises fascinating questions that involve not only the relationship between the broker and customer, but also the needs of society to gather resources for productive endeavors. Stock brokers in the United States have a regulatory requirement to recommend investments that are "suitable" for investors. The Obama administration proposed legislation that would adopt a higher ethical standard. The proposal would make brokers "act solely in the interest of the customer or client without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice."[1] Congress delegated the issue to the U.S. Securities and Exchange Commission (SEC) to study with the authority to impose higher standards.

This paper examines this issue and the ethical logic behind the proposed reforms. A broker is really selling a solution to an investment problem. Sometimes this problem is rather simple: The customer directs the broker to sell a particular security. Here, the duty of the broker to obtain "best execution" is clear.[2] The customer has hired the broker to be the customer's agent to perform a specific and well-defined task. Acting on behalf

[1] http://www.treas.gov/press/releases/docs/tg205071009.pdf. This proposal was incorporated in Section 7103 of the original House version of the Dodd-Frank Wall Street Reform and Consumer Protection Act, HR4193. Section 913 of the bill as passed (PL 111-203) requires an SEC study of the issue and gives the SEC the rulemaking authority to impose fiduciary standards on broker dealers.

[2] Although it is clear that a broker has a duty to obtain best execution, in practice figuring out what best execution is can be problematic. See Macy and O'Hara (1997) for a nice discussion of the complexities and Facciolo (2006) for some of the history behind broker obligations.

of the customer, the broker then uses the broker's skills to execute the customer's trading instructions in a professional and competent manner.

At other times the problem is far more complex: The customer needs to figure out which investments, if any, should be bought or sold. Similar to the recommendations of an auto mechanic or a doctor, the solution involves professional advice customized to the needs of the client as well as its implementation. What is the seller's obligation in this case?

The issue is complicated by the conflict of interest inherent in broker compensation, since brokers are often compensated from commissions on transactions: The best solution for the client may not be the most profitable one for the broker. Yet it is by no means clear that adopting the higher fiduciary standard would yield net benefits to clients or to society.

This issue has received surprisingly little attention in the business ethics literature. Although there have been many articles on the ethics of socially responsible investing as well as on insider trading, there has been very little work examining the ethical issues of the stockbroker suitability standard. Boatright (1999) discusses unsuitable investments, but does not really address the issue of whether suitability is the proper ethical standard. Heath (2010) briefly mentions suitability in his discussion of fairness. Some scholars, however, have discussed related issues. Coyne and Traflet (2007) examine the mass marketing of securities from the perspective of the sales literature, but pay little attention to the issue of what is suitable for a given customer. Bonvin and Dembinski (2002) identify many of the important issues in financial services. Palazzo and Rethel (2007) examine in detail conflicts of interest in financial services. Bigel (2000) looks directly at the ethical orientation of financial planners. Battalio and Loughran (2008) provide a masterful treatment of the ethical issues involved in the practice by which brokerage firms get paid for sending customer orders to firms like Bernard L. Madoff Investment Securities. The selling practices of stockbrokers relate to all selling practices, and are thus are related to the social desirability bias issues discussed in Bellizi and Bristol (2005). Legal scholars have also addressed legal issues of suitability, as this is an important issue in securities arbitrations.[3]

The next section discusses in more detail how brokerage firms make money, which is critically important for understanding the relationship between a customer and a broker.

Follow the money: How brokerage firms make money.

In order to understand the workings of a financial service firm, it is often useful to heed the old Watergate maxim, "Follow the money." In this section we follow many of the different ways in which a modern integrated financial services firm makes money. A typical large firm offers many different services to both institutional and retail clients.

Stock commissions

Every time a customer buys or sells a stock, the firm charges a commission. This fee is plainly disclosed in the confirmation statement that the firm delivers to the customer after

[3] There are a number of law review articles that address suitability in a legal context. See Nichols (1976), Weiss (1997), Libin and Wrona (2001) ,Gedicks (2005), and Hazen(2010),

each transaction. A customer may think that this is all that the firm is making from the account, but the firm is actually generating much additional revenue in ways that are far less transparent. Table 1 displays the total net revenue for U.S. financial firms for 2006. In that year, U.S firms earned a total of $49 billion in commission revenue, roughly one fourth of their total revenue for the year.[4]

The commission-based model creates a direct conflict of interest when advice is involved. The broker only gets paid when a transaction takes place, so there is an incentive for the broker to recommend trades that may not be in the best interest of the client.

Trading profits on stocks

When a customer places a "buy" order on a stock, the firm often fills the order by selling it to the customer from its own account, a process known as "internalization." This method allows the firm to offer faster execution speed, as well as avoid paying a fee to a stock exchange for filling an order. Furthermore, the firm may well have profited by selling the stock to the customer at a higher price than it originally paid. The firm seeks to profit from the "bid-ask spread" by buying securities from customers at lower "bid" prices and selling them to customers at higher "ask" or "offer" prices. This creates a direct conflict of interest between the brokerage firm and the client. In general, the brokerage firm has an agency obligation to provide the client with a "best execution" – a price at least as good as could be obtained elsewhere.[5] However, when the firm is selling

[4] The year 2006 is displayed as a typical year. Large losses during the financial crisis of 2007 and 2008 make those more recent numbers less illustrative of typical years.
[5] One way in which the SEC deals with this conflict is to require brokerage confirmations to disclose where the trade was executed and whether the broker was acting as a principal. See SEC Rule 10b-10.

to the client from its own account, the firm's economic position is diametrically opposed to that of the client: The better the price to the firm, the worse to the client. Whether firms are actually delivering "best execution" and whether unsophisticated clients can determine the quality of their executions is a matter of concern to the public as well as the Securities and Exchange Commission. The SEC has issued several rules designed to increase disclosure of such practices.[6] In practice, however, this disclosure is often boilerplate that is unintelligible to many investors.

Trading profits on bonds

Just as some brokerage firms trade against their customers through the internalization of customer stock orders, many firms also internalize bond orders. The bond market is organized very differently from the stock market. Stocks typically trade on organized stock exchanges, while most bonds typically trade "over the counter" without a central exchange. Once again there is a direct conflict of interest. The broker has a direct incentive to charge a client as much as possible for a bond (or conversely, pay as little as possible when purchasing a bond.) As the bond market is less transparent than the equity market, it is difficult for customers to determine whether they got a good price or not. From time to time, FINRA disciplines firms that charge "excessive" markups on bonds.[7]

Furthermore, brokerage firms are required under Rule 606 to disclose where they route their equity and option orders, as well as payments received for those orders.

[6] SEC Rule 605 requires market centers to report statistics on the quality of their executions.

[7] For example, see Goldman Sachs, Deutsche Bank, Miller Tabak Roberts, Citigroup Global Markets to Pay Total $20 Million for Corporate High Yield Bond Trade Violations, http://www.finra.org/Newsroom/NewsReleases/2004/p010892.

Payment for order flow

If the firm does not execute the order internally, but instead sends the order to an exchange or another broker, it may receive a payment for that order. These payments are typically small, typically far less than one cent per share.[8] This practice is legal in the U.S., although the SEC requires brokerage firms to make some disclosures.[9] Payment for order flow presents another conflict of interest: The broker typically pockets the payment for order flow as well as the commission, so who is the broker really working for? Will the payments received by the broker induce the broker to send the order to an execution venue that provides a worse price to the customer?

Investment banking fees

Furthermore, the firm also acts as an investment bank that helps corporations sell stocks and bonds to investors. The firm uses its large retail client base as a distribution channel for selling these financial products, and earns substantial fees on each deal. Thus, when the firm sells securities on behalf of a corporation, it may well sell some of them to one of its own retail customers. Once again, there is a conflict of interest. There is a strong financial incentive for the firm to push the securities on its own customers.

Mutual fund fees: Loads, management fees, and "12b-1" fees

---

8 For example, E-trade discloses in fine print on its web site: "E*TRADE receives payment from its affiliate, E*TRADE Capital Markets, LLC ("ETCM"), a wholly owned subsidiary of E*TRADE Financial Corp. ("ETFC"), for directing listed equity order flow. Payments received from ETCM averaged less than $.0008 per share. ETCM executes on a principal basis and may have profited or lost in connection with such transactions. https://content.etrade.com/etrade/powerpage/pdf/OrderRouting11AC6.pdf, accessed September 30, 2010.

9 See Battalio and Loughran (2008) for more details.

With stocks, the commission schedule is does not usually vary from one stock to another. Not so with mutual funds. Sales charges vary across different mutual funds, and these differences create incentives for brokers to recommend funds that pay higher commissions even if those funds are not the best funds for the client.

Often these charges are hidden in the form of an annual “12b-1” fee, so named because of the SEC rule that permits the charge.[10] This charge is used to defray the marketing expenses of the mutual fund. In practice, many mutual funds rebate all or part of the fee to the brokerage firm that sold the shares. This is the reason why many brokerage firms can offer “no-load no-transaction fee” funds in their “mutual fund supermarkets” – the brokerage firms are being paid by the mutual funds directly out of the 12b-1 fees. These fees come directly out of the assets of the fund and are under the radar of most investors.

Other areas

Firms also make money like banks: They pay interest on customer cash balances and then lend the money out at higher rates, often to other customers. If the customer accesses the account with a Visa or MasterCard debit card, the firm collects part of the interchange fee paid by the merchant.

In summary, we see that the firm makes more money when the customer brings in more assets to the firm, and purchases financial products from the firm. The profits are made

[10] SEC Rule 12b-1, 17CFR240.12b-1

both through explicit commissions in addition to various hidden fees and trading profits. Indeed, the hidden non-commission part of the revenue is so appealing that some firms offer commission-free trading for some assets or when certain minimum balance requirements are met. In many of these cases, there is a conflict of interest between the firm and its clients.

Investment advisors

Investment advisors offer similar services as brokers, and are often compensated in similar ways through commissions. They are, however, regulated very differently in the United States. Investment advisors register directly with the SEC and are known as Registered Investment Advisers (RIAs).[11] [12] Brokers, on the other hand, do not register directly with the SEC, but instead register with the quasi-private Financial Industry Regulatory Authority (FINRA). FINRA serves as a Self Regulatory Organization (SRO) with authority to set rules and discipline brokers by fining them or banning them from the industry.[13] FINRA also runs arbitration proceedings for disputes between customers and brokerage firms. Some individuals are registered as both brokers with FINRA and as RIAs with the SEC.

[11] The common practice in the U.S. is to use the spelling "advisor." However, the text of the law and most regulations use the spelling "adviser." Both spellings are generally deemed acceptable by many dictionaries. Google reports approximately twice as many hits for "advisor" as "adviser".

[12] Smaller advisors doing business in only one state may register with their state instead of the SEC.

[13] FINRA was formed as a result of a merger between the National Association of Securities Dealers (NASD) and NYSE Regulation in 2007.

In general, RIAs have a fiduciary responsibility to act in their client's best interest, which is stricter than the relatively weak suitability standard. The biggest difference between RIAs and brokers is that RIAs are prohibited from trading as principals against their clients. Furthermore, RIAs are prohibited from compensation schemes in which they participate in the gains or losses of their clients.[14] They may collect commissions, though, on products that they sell to their customers. Many financial advisors portray themselves as "fee only" advisors to indicate that they do not receive commissions on the financial products they recommend. This reduces the financial incentive for them to provide biased advice based on their own commissions.

The brokerage industry responded to criticism that they had incentives to "churn" accounts to increase commissions by introducing "wrap accounts" in which customers paid a flat annual fee and received unlimited trading. This reduces the incentive for brokers to churn accounts merely to obtain commission payments. The SEC had permitted such wrap accounts to be treated as brokerage accounts rather than under the stricter requirements relating to RIAs. However, a 2007 court case invalidated this treatment and forced the industry to unwrap the wrap accounts or else register as investment advisers and abstain from their usual proprietary trading with the accounts.[15]

The similarities between the services offered by brokers and the services offered by RIAs have led to much confusion among customers, and are one of the reasons for proposals to extend fiduciary obligations to brokers. Indeed, many brokers call themselves financial

[14] Section 205 of the Investment Advisers Act of 1940

[15] *Financial Planning Association v. SEC* 482 F.3d 481 (D.C. Cir. 2007). See also SEC (2005ab) and SEC release http://www.sec.gov/rules/final/2007/ia-2653.pdf.

advisors or financial planners or financial consultants, even though they are not RIAs. Consumers are often confused about what standards apply to various financial planners. A survey by Infogroup (2010) found that 34% of the 1,319 investors surveyed thought that the primary business of stockbrokers was giving advice and 66% thought that stockbrokers had a fiduciary duty to their clients.

The situation becomes murkier in large firms that provide a variety of different services. As Goldman Sachs CEO Lloyd Blankfein testified before Congress:

> "I can understand their confusion … There are parts of the business where you are a money manager, where you owe a [fiduciary] duty to the client, there are parts of the business where you are a principal, and you are giving the client what it wants and it's understood where you have to know that they are suitable."[16]

The Suitability Rule

The requirement for stockbrokers to make "suitable" recommendations has evolved over the years. Under a series of common law cases, courts held that when stock brokers were acting as agents they had a duty of loyalty to their clients and that they had a duty not to commit fraud by misrepresenting their products. [17]NASD rules basically required "just

[16]Testimony of Lloyd Blankfein, CEO of Goldman Sachs, April 27, 2010 before Senate Governmental Affairs Subcommittee on Investigations.http://hsgac.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=f07ef2bf-914c-494c-aa66-27129f8e6282

[17] See Weiss (1997) for more details.

and equitable" principles of trade.[18] In 1963, the SEC stated "Whatever the extent of a broker-dealer's legal obligation to recommend securities which are not unsuitable to the particular customer, his ethical duty to do so is clear under the express language of [NASD rules]. [19]

The Suitability Rule is codified as NASD (now FINRA) Rule 2310:

Recommendations to Customers (Suitability):

> *(a) 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.*
>
> *(b) 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.*

This rule applies to all broker dealers that are members of FINRA, which is the majority of securities personnel in the United States. Note that the current rule has two major parts. The first part is that the broker has "reasonable grounds" to believe that the recommended security is suitable. The second part imposes an affirmative obligation on

[18] The National Association of Securities Dealers (NASD) was a predecessor of FINRA. NASD Rule 2010 stated "A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."
[19] SEC Special Study of the Securities Markets, (1963), pt 1.Page 238.

the broker to find out information from the client to be able to make a suitable recommendation.[20] This customer specificity is an important part of the rule. The broker must do the homework to understand not only the product, but also the customer in order to have reasonable grounds to believe it is suitable to the customer. A particular risky security might be very suitable for one customer's account, but unsuitable for another.

Boatright (1999, page 78) lists five categories of unsuitable investments:

1) *Unsuitable types of securities.* Sometimes a particular type of security is plainly unsuitable for one customer even though it might be suitable for another investor. For example, some investments are so complex that they are not suitable for investors who do not understand them, because they may not understand the risks they are taking on. Some asset-backed auction rate securities, for example, contain explicit language in their prospectuses stating they are unsuitable for people who do not understand them.
2) *Unsuitable grades of securities.* It would be unsuitable to recommend a junk bond to an investor who could not bear the default risk or who specifically requests investment grade securities.
3) *Unsuitable diversification.* One of the basic principles of investments is the need for prudent diversification. Excessive concentration in a risky asset leaves a client extremely vulnerable if that asset declines in value. For example, it would be unsuitable for a broker to permit a 70 year old retiree to put 99 percent of his portfolio into a single dot-com stock.

[20] The NYSE has long had the similar Rule 405, the "Know your customer" rule.

4) *Unsuitable trading techniques.* A broker might encourage an unsophisticated investor without any particular skill to engage in highly risky investment techniques such as short selling or the trading of options and futures. It would be unsuitable if the customer could not understand the risks of the techniques or bear the risks involved. Likewise, "churning" an account involves excessive trading in order to generate higher commissions.
5) *Unsuitable liquidity*. Some investors need to be able to liquidate their investments in order to meet planned or unplanned cash needs. It would be extremely unsuitable to put such investors needed reserves into illiquid securities such as limited partnerships that cannot be turned into cash when needed on reasonable terms.

One way to understand the difference between suitability and a higher best-interest fiduciary standard is as follows: A customer approaches a car dealer and sits down with a Car Advisor to discuss his automotive needs for a car to get to work. The Car Advisor asks lots of questions about his automotive and financial situation, and then recommends a fancy gas guzzling sports car which just happens to provide the Car Advisor with the highest profit. The Car Advisor also recommends an overpriced extended warranty which would generate even more profit. The sports car with the extended warranty is suitable because it will transport the customer to work, and the customer can afford the payments and insurance costs, albeit with some difficulty. It is not necessarily the best solution for the customer. If the Car Advisor adhered to a best-interest standard, the recommendation would have been for a more affordable and more reliable vehicle.

The ethics of suitability

The ethical dimensions of the current debate over suitability versus fiduciary duty become clearer when one views the product being sold by the stockbroker not as a stock or a mutual fund, but as a solution to a financial problem. The customer comes to the broker with a particular problem, such as saving for retirement. The services provided by the broker include designing a solution to the problem as well as implementing that solution through the purchase of investment products.

One could view the ethical situation as similar to that of the seller of any product, a question that has been discussed for millennia by ethicists including Cicero, St. Thomas Aquinas, and Nider (1966).[21] The basic consensus is that sellers have an obligation to disclose defects, because not to do so would be fraud. However, although opinions vary, sellers do not necessarily have to tell the customer that another seller has a better one for sale at a lower price. In short, *caveat emptor*. It is the buyer's responsibility to shop around for the best price. But what if the buyer thinks he or she is hiring the seller to do the shopping?

[21] See Goldin (2006) for a concise and readable discussion of Cicero's and St. Thomas Aquinas' views on the matter.

To be specific, suppose that a buyer is hiring a broker as an agent to execute a trade. In that case, the broker has a duty of loyalty to the customer to do the shopping around to get "best execution" for the buyer. However, the customer presumably knows what the brokerage commission is, and the broker is not under an obligation to say that another broker could do the same job for a lower commission.

But what if the essential nature of the product is the advice itself, and the implementation is more incidental? In that case, it seems pretty clear that the broker should have an obligation to offer advice that is in the best interest of the customer. To do otherwise is fraud, because then the service delivered would not be what the customer thinks he or she is buying. When there are conflicts of interest, these should be clearly disclosed so that the customer understands the conflicts and how those conflicts may affect the advice that is given.

However, the problem becomes more nuanced when one considers the issue of how to pay for that advice. Financial professionals who provide useful advice deserve to be compensated for their time and expertise. Often, the compensation for this advice is in the commission charged for the financial product purchased. In many cases, the commission charged for execution is more payment for the advice than for the actual execution. For example, many sophisticated institutional investors willingly pay much higher commissions to brokerage firms that provide useful information ("research"), even though those commissions are far more than those charged by low-cost "execution only" brokers. In a retail situation, the broker sells a mutual fund with a sales charge to a client when the client could have bought a similar no-load fund with no shares charge. However, the sales commission is the compensation to the broker for sitting down with the customer to design a financial solution that meets the customer's financial needs. Did the advisor give bad advice because he suggested a higher cost fund when the investor could have purchased a no-load fund with the same expected performance but at lower cost? Or was the sales charge appropriate compensation for the time and expertise needed to design the product recommendation?

Given the large conflict of interest in the commission as compensation model, the obvious question is why this practice remains as such a major part of the advice industry. Why hasn't commercial competition from conflict-free "fee only" financial planners driven the commission-driven firms out of business? Why do even very sophisticated customers tolerate this practice?[22] While "fee-only" financial planners exist they are a minority in the financial advising profession. Some practitioners cite behavioral norms in which investors do not like to write explicit checks for advice but instead prefer the less visible fees implicit in the commission model.

One potential solution to this question arises when we consider the needs of other stakeholders in our financial markets. The purchase of a financial product involves not only the investor and the distribution channel frequented by the investor, but also the issuer of the product as well. Our society uses financial markets for many things.

[22] Here is a personal anecdote to illustrate how even sophisticated investors knowingly consume commission-based advice. The mother of one of our colleagues obtains financial advice from a commission-based advisor. She then cross checks the advice with her son and asks him what she should buy from the advisor "that is not too bad because I need to buy something to pay him for his advice."

Financial markets direct the allocation of investment into productive enterprises that create goods and services. Without the ability to gather the large sums needed to fund large scale enterprises that can take advantage of economies of scale, everyone would be much poorer. Financial markets permit individuals to finance purchases of products ranging from cars and houses to education and flat-screen TVs. Financial markets provide tools for individuals, governments, and corporations to reduce their risks through diversification and hedging – or take on risks through speculation. Society depends on financial markets to do these jobs fairly and efficiently.

Issuers of financial products face a very crowded and competitive marketplace. There are over 10,000 stocks, over 10,000 mutual funds, and nearly 10,000 hedge funds to pick from in the U.S. alone. Just like the producers of any other product, these issuers of stocks, bonds, investment funds, and other risk management products need access to distribution channels. Financial products do not sell themselves any more than any other product does. If an investor does not know about an investment opportunity they are not likely to invest. It is costly for issuers to find investors and it is costly for investors to find the right investments. The investment banks, their associated brokerage arms, and other financial advisors provide these important distribution channels. Even after securities are sold to the public for the first time in the primary market, issuers need to be concerned about how their securities are trading in the secondary market because that will affect their ability to raise capital in the future. Investors generally do not like to buy securities that are not actively traded because transactions costs tend to be high. There is thus a need for continued marketing support for a firm's stock long after it is originally sold to the public.

Distribution channels don't work for free, and they need to be compensated. The "sell side" of financial services (brokerage firms and investment banks) has thus evolved as a financial intermediary providing essential distribution services to issuers (corporations) and at the same time providing financial solutions to investors. In order to market securities, paying the distribution channels for performance – sales commissions -- appears to be the appropriate solution for the issuers. After all, that is how most distribution channels work. Furthermore, different products require different degrees of effort to get sold, which means different levels of commissions and profitability to the distribution channels. Issuers thus prefer a commission-based distribution channel because of its ability to move the product.

Alas, the most appropriate solution for the issuers is fraught with conflicts of interest for the investors, as we have seen. This is a type of ethical pollution that motivates unethical behavior for financial gain. While sophisticated customers may understand the nature of the conflicts and know how to proceed with appropriate caution, the most vulnerable consumers most certainly do not.

It might seem ideal to remove all of the conflicts of interest inherent in the relationship between broker and customer. However, this is quite difficult to do. Even a "fee-only" planner has an incentive to shirk and not devote the effort needed to design the best solution for the client. Furthermore, attempts to eliminate conflicts by eliminating the commission model risk reducing the ability of firms to raise capital for productive investments.

Viewing the conflicts of interest in financial services as a type of ethical pollution provides some useful insight into possible approaches to the problem. Our society tolerates some pollution as a byproduct of other useful activities such as the production of goods and services. It is not technologically, let alone economically, feasible to eliminate all pollution while still producing useful goods and services. We thus attempt to strike an appropriate balance between pollution and production with a variety of policies including laws, taxes, and other regulations.

The reputation of a financial firm for integrity is also vitally important for resolving this conflict of interest. Most investment relationships are not one-time events, but are part of a longer-term relationship. Even though it may take years to determine the quality of a particular bit of financial advice, over time firms develop a reputation for quality – or lack thereof. A firm that develops a reputation for harming its customers will soon find itself in the historic dustbin of dead financial firms.

To a certain extent, the industry is already moving towards a "best interest" standard. The CFA Institute (2005), keeper of the Chartered Financial Analyst (CFA) professional designation, actually has both suitability and best interest in its Code of Ethics and

Standards of Professional Conduct. It both requires members to "act for the benefit of their clients and place their clients' interests before their employer's or their own interests". Furthermore, it also requires members in an advisory relationship with a client to make sure that "an investment is suitable to the client's financial situation and consistent with the client's written objectives, mandates, and constraints before making an investment recommendation or taking investment action." Alas, not all practitioners adhere to the CFA code of ethics.

Conclusions

Stockbrokers sell solutions to financial problems, such as retirement planning, to their clients. These solutions often include professional advice and custom engineering of financial products to meet the customer's needs. However, there are numerous financial conflicts of interest between the customer's best interest and the stockbroker's, a form of ethical pollution. The highest fee generating strategy for the firm is often not in the customer's best interest.

The current requirement that brokers only recommend "suitable" investments is quite weak. The suitability requirement only holds that the product is not defective – it is a solution to the client's problem, but it may not be anywhere near the best solution. Current proposals would impose a duty that on a broker to act in the "best interest" of the client. This is appropriate in the cases where the primary component of the solution sold is the investment advice, and also in cases where the broker is acting as an agent to execute a specified transaction. It is not appropriate in cases where the broker is acting purely as a principal trading for its own account with a knowledgeable counterparty who understands that the broker is acting as a principal, not as an agent.

The issue is complicated by the interests of other stakeholders, in particular the issuers of securities. In order to raise capital or transfer risk, they depend on the distribution channel of the financial services industry to market their securities. The commission-based compensation structure provides powerful incentives for the distribution channel to do that marketing.

Just as society tolerates some pollution as a byproduct of useful production activities, it is appropriate to tolerate some ethical pollution - conflicts of interest - as a byproduct of the capital raising process. However, it is important to reduce the damage from this pollution through appropriate disclosure of the conflicts.

The relationship between a customer and the financial practitioner should govern the nature of their mutual ethical obligations. Where the fundamental nature of the relationship is one in which customer depends on the practitioner to craft solutions for the customer’s financial problems, the ethical standard should be a fiduciary one that the advice is in the best interest of the customer. To do otherwise – to give biased advice with the aura of advice in the customer’s best interest – is fraud.   This standard should apply regardless of whether the advice givers call themselves advisors, advisers, brokers, consultants, managers or planners. While it is not practical to eliminate all conflicts of interest, just as it is not practical to eliminate all pollution, the potential damage from conflicts of interest can be minimized through clear disclosure of the conflicts to customers.

At the other end of the spectrum, there is a pure principal trade. In this relationship, the wary and well informed parties merely seek to get the best terms they can on a particular trade. There is no provision of advice, nor is there any representation that the customer should engage in transaction or that the price terms are good. Here there are no particular obligations beyond not committing fraud. Indeed, each party has an obligation to its own stakeholders to get the price it possibly can.

In other cases in between, the relationship is an agency relationship with a limited mandate. For example, a customer may make her own investment decisions and merely hires a broker to implement those decisions. Here the broker has the standard duty of loyalty and care that any agency relationship involves, but not an obligation to determine the best investment strategy for the client. Indeed, the customer may have chosen not to reveal private information to the broker that the broker would have needed to determine what was best for the client.

Another limited mandate is that of a service provider. For example, a client may hire a money manager to manage a bond portfolio. The bond fund manager has an obligation to perform that service in the customers' best interest, consistent with the narrow mandate given. However, the manager of a bond fund would not necessarily be expected to advise the client not to invest in bonds or that another bond manager has a better track record.

Clarifying the nature of the relationship is important in that it helps both sides understand their ethical obligations. Practitioners should be required to clearly disclose the relationship in which they are acting in any given situation: principal, agent, service provider, or advisor. These disclosures should be in large print in all transaction confirmations in a standardized manner.

References

Battalio, Robert H., and Tim Loughran, 2008, Does Payment for Order Flow To Your Broker Help or Hurt You?, *Journal of Business Ethics* 80:37–44

Bellizzi, Joseph A., and Terry Bristol, 2005, Supervising the Unethical Selling Behavior of Top Sales Performers: Assessing the Impact of Social Desirability Bias, *Journal of Business Ethics* 57: 377–388

Bigel, Kenneth S., 2000, The Ethical Orientation of Financial Planners Who Are Engaged in Investment Activities: A Comparison of United States Practitioners Based on Professionalization and Compensation Sources, *Journal of Business Ethics* **28**: 323–337.

Boatright, John Raymond, 1999, *Ethics in Finance*, John Wiley

Bonvin, Jean-Michel, and Paul H. Dembinski, 2002, Ethical Issues in Financial Activities, *Journal of Business Ethics* 37, 187-192.

CFA Institute, 2005, Code of Ethics and Standards of Professional Conduct, available at http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2005.n8.4568.

Coyne, Michael P., and Janice M. Traflet, 2007, Ethical Issues Related to the Mass Marketing of Securities, *Journal of Business Ethics* 78:193–198

Facciolo, Francis J., 2005, A Broker's Duty of Best Execution in the Nineteenth and Early Twentieth Centuries, *Pace Law Review 26*, 155-182.

Financial Industry Regulatory Authority (FINRA), 2007, NASD Manual, Rule 2310. Recommendations to Customers (Suitability) http://finra.complinet.com/finra/display/display.html?rbid=1189&record_id=1159000499&element_id=1159000500&highlight=suitability#r1159000499.

Gedicks, Frederick Mark, 2005, Suitability Claims and Purchases of Unrecommended Securities: An Agency Theory of Broker Dealer Liability, *Arizona State Law Journal* 35, 535-588.

Goldin, Owen, 2006, Ciceronian Business Ethics, *Studies in the History of Ethics*, available at http://www.historyofethics.org/112006/GoldinCiceronianBusEthics.pdf.

Hazen, Thomas Lee, 2010, Are Existing Stock Broker Standards Sufficient? – Principles, Rules and Fiduciary Duties, *Columbia Business Law Review*, forthcoming

Heath, Eugene, 2010, *Fairness in Financial Markets, in Finance Ethics: Critical Issues in Theory and Practice (Robert W. Kolb Series)*, John R. Boatright, editor, Wiley. Chapter 9, pages 163-178.

Hunt, S. D. and S. Vitell: 1986, 'A General Theory of Marketing Ethics', *Journal of Macromarketing 6* (Spring), 5–16.

Infogroup/ORC, 2010, *U.S. Investors & The Fiduciary Standard: A National Opinion Survey*, available at http://www.cfp.net/downloads/US_Investors_Opinion_Survey_2010-09-16.pdf, accessed September 30, 2010.

Libin, Nancy C., and James S. Wrona, 2001, The Securities Industry and the Internet: A Suitable Match? *Columbia Business Law Review* 601.

Macy, Jonathan, and Maureen O'Hara, 1997, The Law and Economics of Best Execution, *Journal of Financial Intermediation* 6, 188-223.

Nichols, F. Harris, 1976, The Broker's Duty to His Customer under Evolving Federal Fiduciary and Suitability Standards, *Buffalo Law Review* 26, 435-455.

Nider, Johannes, 1966, *On the Contracts of Merchants*, (*De Contractibus Mercatorum*) Translated by Charles H. Reeves, University of Oklahoma Press.

Palazzo, Guido, and Lena Rethel, 2008, Conflicts of Interest in Financial Intermediation, *Journal of Business Ethics* 81:1 193-207.

Ross, William T., and Diana C. Robertson, 2003, A Typology of Situational Factors: Impact on Salesperson Decision-Making about Ethical Issues, *Journal of Business Ethics* 46: 213–234,

Securities and Exchange Commission, 2005a, Certain Broker-Dealers Deemed Not To Be Investment Advisers ([Release Nos. 34–50980; IA–2340; File No. S7–25–99), *Federal Register* / Vol. 70, No. 10

Securities and Exchange Commission, 2005b, Regulation NMS, Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496

Weiss, Cheryl Goss, 1997, A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty, *Journal of Corporate Law* 23 65-119.

Table 1

Total U.S. Broker-Dealer Revenue 2006

Source of Revenue	Revenue ($ billions)
Commissions	$49
Trading and investment gains	$49
Underwriting	$24
Margin Interest	$24
Mutual fund sales	$23
Asset Management Fees	$28
Other	$24
Total Net Revenue	$221

This table displays the net revenue reported by members of SIFMA in 2006.

Source: Securities Industry and Financial Markets Association, SIFMA.org