January 30, 2011

The following recommendation covers several topics such as fiduciary responsibility, conflicts of interest, exemptions, etc.

(i) Retail banks, credit unions, thrifts, etc. are in the business of making loans. They should all have the same regulator. They have no fiduciary responsibility to the buyer, but should be subject to full and fair disclosure regulations so that consumers can make easy comparisons as to which to do business with.

(ii) Investment banks should be restricted to representing the “sellers”. They represent the companies in M&A, IPOs, stock and corporate bond issues, the municipality in muni bond issues, etc. Again, they have no fiduciary responsibility to the buyer, (maybe to the seller), but should be subject to full and fair disclosure regulations.

(iii) Mutual fund companies, insurance companies, hedge fund companies, etc. also represent the sellers (themselves) so should be subject to full and fair disclosure regulations. The investment managers within the investment products should have a fiduciary responsibility for the funds they manage (i.e. they have to follow their prospectus). Any sales staff employed by the fund/insurance company should have the word ‘sales person’ in their title and not ‘advisor’ or anything similar. There is nothing wrong with being a product sales person working for a product company, just don’t pretend to be working for the client.

(iv) The three above types of entities are similar from a regulatory point of view (i.e. they all represent the seller) so can be part of the same business, i.e. a retail bank can own an investment bank (to collateralize mortgages and other loans originated by the bank).

(v) Brokerage companies, investment advisors, family offices, etc. should only represent the buyer of products, therefore should have fiduciary responsibility to the buyer. They should have the same regulator, and be subject to the same standards. Neither type of company should be owned by a retail bank, investment bank, or have their own proprietary products. Employees should have the same training. There should be no conflict of interest. They should be able to charge an annual fee, or hourly fee, or per-trade fee so clients can still choose how they want to pay. However, no commissions built into the investments themselves (mutual fund front load is fine as clients see it, but no 12(b)1 fees, CDSCs, etc.)

Even today, investment advisors have a conflict of interest. Many are not insurance-licensed. I’ve seen several liquidate clients’ insurance products purely to get the cash value in order to have more money in stocks and bonds on which they can charge a fee, even though the insurance product was more appropriate for the client. I’ve also seen plenty of people who were sold inappropriate annuities by ‘financial advisors’ without the client realizing they were dealing with an insurance salesman who could only sell annuities (and who didn’t want to lose a sale).

The general public used to be able to rely on social security, a company pension, and maybe their own savings for retirement. Company pensions are going away, social security will pay a lower proportion of retirement expenses in future, so people are going to depend a lot more on their own savings and investments. We need to have advisors that represent the public (be it retail investors, endowments, foundations, pension funds) without the present conflict of interest. That independent company does not presently exist (like I said, even today’s investment advisors have a conflict of interest). Now’s your chance to act. To start with:

(i) Get ownership of the brokerage companies away from the retail banks, investment banks, insurance companies, etc

(ii) Ensure the brokerage companies/investment advisors do not have their own proprietary products.

(iii) Ensure the brokerage companies/investment advisors have a minimum breadth of products available, or disclosure that they only deal with certain classes of products but not others (e.g. we deal with stocks and bonds, but not insurance, hedge funds, managed futures)