A RANT — ETHICAL SHORTCOMINGS IN MY INDUSTRY

THE DEPARTMENT OF LABOR ISSUES ITS "FIDUCIARY RULE"

In an effort to reduce the financial services industry's ability to fleece investors as often or as severely, the Department of Labor (DOL) recently proposed its new Fiduciary Rule. Actually, it proposed the rule in 2010, but the industry resisted it so the rule it proposed a few days ago is a revised version. Congress is now mulling it over.

Since the topic has garnered some press, I can't resist sharing with you some sobering details that also deserve some attention. The optimist in me would like to believe that the industry resisted the DOL's original proposal because it felt the rule needed more teeth to adequately protect the investing public. However, the realist in me knows that the industry had its own interests in mind.

WHEN MIGHT AN INVESTMENT ADVISOR *NOT* BE ON YOUR SIDE?

A: When he or she is *not* a fiduciary.

Within the financial planning and investment management industries, advice may be rendered according to one of two standards of ethical conduct — a *fiduciary* standard, or a *suitability* standard.

Fiduciary: One who has a legal duty to act *solely* in another party's interest.

The law typically requires a fiduciary standard of conduct in relationships that are inherently unequal in terms of information and/or power. Since trustees and guardians possess a disproportionate amount of power over those they protect, and because physicians and attorneys possess an asymmetrical information advantage over the patients and clients they serve, they are held to a fiduciary standard of loyalty and care.

At this point in my life, I still don't know when my doctor is going to ask me to drop my drawers and I still don't really grasp how kidneys get tangled up with blood pressure, so when he suggests something to me, I pretty much go along with the program because I figure he has no reason to abuse me. A big chunk of the investment industry wants you to have this same cozy feeling, but it doesn't really want to deliver on the promise.

THE "SUITABILITY STANDARD" — A MONEYMAKER

Whereas the fiduciary standard of conduct can be boiled down to doing whatever seems right for a client, the suitability standard's reason for being is to make it hard to prove an advisor or advisory firm has done anything wrong. In short, the suitability standard occupies an odd space of appearing to protect investors' interests while, in actuality, it arms the industry with the flexibility it needs to pursue its revenue goals.

Here are just two examples that show how the suitability standard masquerades as a consumer protection measure, but is in reality a moneymaker for the advisors and advisory firms that are governed by it.

EXAMPLE #1: PRIVATELY-REGISTERED REITS

Imagine a situation where an investment advisor thinks a real estate investment trust (REIT) might make sense for a client's portfolio. *Publicly*-traded REITs (the only kind we use) can be bought or sold in a matter of seconds with minimal transaction costs on a public stock exchange. Because they are widely held, they are regularly scrutinized by major research firms which provides investors with an objective glimpse of their investment merit. This structure gives investors a fair shot at investment success.

In contrast, *privately*-registered REITs do not trade on public stock exchanges. They require copious amounts of paperwork to buy, can be difficult or even impossible to sell, and are often loaded with sales charges and sneaky fees. Since there's no public market for privately-registered REITs, investment analysts tend to ignore them which creates a cloak of darkness that also helps conceal their shortcomings. This structure allows the industry to create one-sided deals and to then foist them on an unsuspecting public.

GOTTA GET 'EM IN INVESTORS' HANDS THOUGH

To help privately-registered REITs find their way to the investing public, REIT sponsors will typically wave some financial smelling salts in front of advisors (figure a 7% commission) to get their attention. Figure another 3% for offering expenses which are expenses incurred by REITs to help make advisors "aware" of how good they are for clients. We're at 10% so far, but for purposes of this example, I'll stop there. Just remember that publicly-traded REITs are not burdened by such fees.

LET HIM PAY BECAUSE HE WON'T KNOW HE IS ...

Of course, that 10% comes out of investors' pockets, but Wall Street knows they mostly won't know its missing. Since there's no public market for privately-registered REITs, investors will have a hard time noticing that 10% of their investment went AWOL the moment they signed on the dotted line. Sure, investors will receive statements detailing their investment, but an estimated value of their investment will not be forthcoming until the REIT decides to get its holdings appraised.

EXAMPLE #2: "CLOSED-ENDED" MUTUAL FUNDS

Most mutual funds are structured as "open-ended" mutual funds. Open-ended funds stand ready to issue shares to or redeem shares from their investors. In contrast, closed-ended funds issue shares only when the fund is first created. If an investor wants to buy or sell shares after that, he'll have to do it through a public stock exchange.

That's no particular problem, but here's where things get interesting. To exist, a closed-ended fund must undergo an initial offering which just means its shares must first be sold to some initial group of investors before the shares begin trading on a public exchange. The only advisors who are in position to make those initial sales are those who are also licensed to sell securities. (Remember that, for later.)

Of the money that's initially invested in such funds, 10% can easily evaporate in the form of sales incentives and other fees the same way it does for privately-registered REITs. Wall Street loves this structure because it's great for revenues.

However, the 10% the advisor and promoter sucked out of the deal will come into investor view once the shares begin trading on the public markets. So, folks who were guided by their advisors to buy shares at the time of the initial offering will sustain a loss of 10% before they have their first chance to sell. That loss may surprise the trusting folks who bought those initial shares, but it cannot possibly surprise the advisor who sold the shares. On the chance an investor might question his immediate 10% loss, I can't imagine things going well if the advisor were to explain the transaction truthfully.

It gets worse though because closed-ended funds have a long history of trading at substantial discounts to their inherent value. So, that initial loss of 10% can easily grow to 15 — 18% within a month or two because shares of closed-ended funds typically trade at substantial discounts to their intrinsic value. Advisors might not understand why such discounts exist, but what really matters is that they know they do.

THE SUITABILITY STANDARD — THE GREASE THAT MAKES WALL STREET GO

All in all, it's common for shares of closed-ended funds to lose maybe 15—20% of their initial value soon after they come into existence, but again, those losses apply *only* to investors who happen to associate themselves with advisors who are incentivized to sell that crud. While the advisor and his firm are splitting their 7% commission, the folks who followed the advisor's lead are left to wonder where 15—20% of their money went.

Q: Would anyone opt to buy anything if he knew that waiting a few days would result in a discount of at least 10%?

A: Not unless he had an incomplete picture of the facts.

Q: Isn't the advisor supposed to make investors aware of those facts?

A: Decency suggests it, but only a fiduciary standard of conduct requires it.

Q: When might an advisor adhere to a fiduciary standard of conduct?

A: Some never do, some sometimes do, and some (like us) always do.

Wall Street knows it's easier to take advantage of people if it can first get them to relax their guard, so the industry's rules were pieced together with that in mind. Even though an advisor might be operating below a fiduciary standard, it is relatively easy to leave a client with a different impression. This is where a good haircut, a winsome smile, and some well-crafted ads on Monday Night Football come into play. In contrast, the *only* way to really know if an advisor or his firm are really on your side is to review their regulatory disclosures.

GENERIC TITLES & PROFESSIONAL AURAS

The financial services industry's primary goal is to sell things to the public. To take advantage of the fact that most people will not spend the time to discern between people who are incentivized to sell those things and people who might actually be part of some profession, the industry relies on the use of generic titles to help create a professional aura around its sales force. So, after would-be advisors spend a couple of months obtaining the licenses they'll need to sell whatever it is their firms sell, their firms will then often promote them to the public using a variety of assuring titles that, in reality, are professionally empty. Popular choices include variants of, Financial Advisor, Financial Consultant, Investment Counselor, Financial Specialist, Financial Planner, and even Vice-President.

WHEN MIGHT AN ADVISOR BE DOUBLING AS A SALESPERSON?

When people shop for a car, they mostly know to remain wary of statements made on behalf of the dealership, but when they receive financial advice, they often have no idea whether the person with whom they're dealing is representing their interest, or that of some other entity. Since financial salespeople are the only ones who are even in a position to represent anyone other than the client, identifying them can be worth the effort. Advisors who are able to sell securities will typically hold a "Series 6" or "Series 7" license and anyone who can sell annuities or other insurance products must have the requisite insurance license. Many advisors are licensed to sell securities and insurance.

DON'T ADVISORS *HAVE* TO SELL THINGS IN ORDER TO FUNCTION?

No. Firms may tout their reps as being "fully licensed" because they know it makes anyone who does not hold various sales licenses seem comparatively incomplete. The reality is that those sales licenses have nothing to do with the ability of an advisory firm to access the capital markets *on behalf of* its clients. Only in cases where an advisor is also licensed as a salesperson would he even be *able* to pursue the interest of someone other than his client. It is for this reason that no one within this practice has ever had or ever will possess any type of financial sales license, yet we still have wide-ranging access to the capital markets.

SALESPEOPLE MAY NOT NEED TO LOOK BACK

Whereas investment management firms that adhere to a fiduciary standard of conduct are charged with monitoring the investments they place in clients' accounts, salespeople are under no such obligation. They are free to focus on the next sale without ever having to look back. To be fair, many salespeople do behave ethically, but if all of them did, closed-ended funds would have a hard time coming public and privately-registered REITs might not even exist.

REMOVING COMMISSIONS FROM THE COMPENSATION EQUATION ...

What seems the surer bet, a kid who promises to not eat his candy, or a kid who doesn't have any candy to begin with? While the first kid *might* remain candy-free, the second kid pretty much has to.

In that same spirit of high ethical conduct, some advisory firms that already adhere to a fiduciary standard choose to further raise the ethical bar by contractually promising to their clients to not accept *any* form of compensation from *any* party other than the clients they serve. That promise, which is then enforced by regulators, pretty much removes the financial candy from the equation. Therefore, even in cases where a fiduciary might be tempted to stray from his promise to pursue a client's best interest, it would be much harder to act on the impulse.

... RESULTS IN AN EVEN HIGHER STANDARD — THE "FEE-ONLY" CONCEPT

Advisory firms that formally vow to take the financial candy off the table are said to be "fee-only." We have adhered to this standard since we began operating in 2003. In all that time, we've received one box of donuts, a set of headphones, two boxes of golf balls, and a bunch of Christmas cards from people we don't know who nonetheless seem very interested in convincing us to convince you to like them.

After we received that second box of golf balls, we told the company to put the golf-ball money it sets aside for us toward making their mutual funds less costly. It took at least half of our advice because we now have to buy our own golf balls.

HIGHLIGHTING A CENTURY'S WORTH OF LOW STANDARDS

If Congress adopts the DOL's revised fiduciary rule, *only then* would advisory firms be required to do a bunch of things you might have assumed the industry would already have been doing, as shown on the next page.

ADVISORS DON'T ALREADY HAVE TO BEHAVE THIS WAY?

Only then would advisors be required to:

- Render impartial advice,
- Render advice that is in the best interest of the client,
- Limit compensation, whether received directly from the client or indirectly from one or more third parties, to a reasonable amount,
- Make no misleading statements about investment transactions, compensation, and conflicts of interest, and
- Disclose the fees, compensation, and material conflicts of interest associated with any advice that is rendered.

NO — AND THESE NEW STANDARDS WOULD APPLY ONLY *SOME* OF THE TIME!

That's right. Even if Congress adopts the DOL's proposed standards, non-retirement accounts will still be fair game for advisors and firms that continue to operate below the fiduciary standard of conduct.

So, the next time you see an ad portraying some investment firm's deep concern for your financial well being, just know there's a good chance that if the sponsor had its way, a fiduciary standard of conduct might not even be a thing.

This week, Goldman Sachs finally admitted it defrauded investors prior to the meltdown of 2008/9 and agreed to a $5.1 billion settlement. Goldman Sachs is the fifth major investment firm to reach a multi-billion dollar settlement with the Department of Justice relating to misdeeds of that era. To get a sense of the rot that lurks within this industry, visit YouTube, then type "How much of that sh*tty deal did you sell to your clients?" The answer appears to be at least $600 million, and most importantly, the firm seems to have promoted the deal even more vigorously after concluding the deal was sh*tty.

To see a few more ways in which the financial services industry continues to tilt the game in its own favor, flip the page.

— Glenn Wessel

OTHER PRACTICES WE'VE SWORN OFF

1. **DOUBLE DIPPING**: Many firms charge portfolio management fees while also accepting commissions from the sponsors of the products they place in clients' portfolios.

2. **SOFT DOLLARS:** Many firms arrange for clients to pay more than they otherwise would for certain third-party services. In exchange, they are rewarded in the form of free services, goodies, and other things that don't get reflected on the books. Investors aren't in position to notice, so they pay in the form of higher fees and lower returns.

3. **12B-1 FEES**: Mutual fund operating expenses are often higher than necessary so they can funnel some money back to the firms that promote their funds. The industry masks these fees by referring to them by the obscure rule that permits them to exist. One might assume that this type of charge would not be permissible in a no-load (no-commission) mutual fund, but as you might expect, one would be wrong.

4. **AFFILIATED BUSINESSES**: Firms whose advisors are also salespeople tend to also have incestuous networks of mortgage, insurance and investment affiliates. These affiliates tend to price their services the same way gas stations price their groceries.

5. **FINANCIAL PLANS AS A SELLING TOOL**: Many firms offer financial plans to qualified prospects at deep discounts to get them in the door. Why risk turning a prospect off over the cost of a $4,000 financial plan when you know you can use that plan to promote the things you want to sell anyway? Even if a client takes only part of the advice and buys just one $100,000 annuity, the commission derived from that sale could easily dwarf the $4,000 planning fee the firm declined to charge. Selling a life insurance policy could net a firm 120% of the first year's premium plus renewal commissions. A new mortgage? Figure at least 1% of the mortgage amount plus other sweeteners if the firm has its own mortgage affiliate. Then, there's life, disability, and long-term care insurance, home equity loans, credit cards, etc.

6. **COMPENSATION FOR REFERRALS**: Paying for a referral is an underhanded practice because it casts doubt on the referrer's motives and raises the cost of service to the recipient. To know of this practice, you'll probably have to read the fine print.