FINRA Talks a Good Game

By Kerry Pechter *Thu, Nov 14, 2013*

FINRA's recent report on conflicts of interest at brokerages laid bare some dingy practices. Some say it's a move to burnish FINRA's credentials as a candidate for regulator of all brokers and advisors under a uniform fiduciary rule.

Until FINRA published "A Report on Conflicts of Interest" recently, some of us could only guess at the specific opportunities, incentives and temptations to abuse their positions of trust that registered reps contend with in the course of serving the typically under-informed retail brokerage customer.

Now there's no need to rely on the imagination. The Financial Industry Regulatory Authority's 44-page report (which one commentator called a stunt designed to further FINRA's candidacy as the future self-regulatory authority for all financial intermediaries, including fee-only advisors) spells them out. If seamier details exist, we'd have to send the children from room.

Talk about *disclosure*. The report urges broker-dealer managers, for instance, to be especially watchful for unsuitable sales by brokers who are approaching thresholds for bonuses—bonuses presumably set by the managers themselves. If this report fell into the hands of consumer activists, it might impact brokerages as much as Upton Sinclair's 1906 expose, "The Jungle," impacted the meatpacking industry. That's an exaggeration, but not a huge one.

Most brokers and their organizations are undoubtedly scrupulous. And life is full of conflicts. But if the end-customer ends up paying, directly or indirectly, for sales incentives or revenue-sharing whose purpose is simply to drive *volume*, that's hard to justify. Customers patently don't like what they see (or don't see, since conflicts by nature have to be hidden). That's why Vanguard, with its tiny fees and salaried phone representatives, manages $1.8 trillion in assets, netting $60 billion so far this year and a league-leading $6 billion in October alone.

But back to the report. The second sentence of the first paragraph is a sockdolager. "While the existence of a conflict does not, *per se,* imply that harm to one party's interests will occur," it calmly said, "the history of finance is replete with examples of situations where financial institutions did not manage conflicts of interest fairly." The word "replete" represents a much bigger concession to critics than the traditional "few bad apples" defense ever allowed.

"This report…" the unidentified author writes a few lines later, "emphasizes that firms should do more to manage and mitigate conflicts of interest in their businesses." We've entered *mea culpa* territory here. The report goes on to mention the many ways that brokers can take advantage of their possession of much more information than most customers will ever have.

Below are references in the report to potential conflicts of interest. (Heaven help the customer whose broker is just shy of a sales threshold.)

- "…complex products are sold to less knowledgeable investors, including retail investors."

- “The incentive to increase revenue from product sales by using distribution channels… may not have adequate controls to protect customers’ interests.”
- “Pressure to prefer proprietary products to the detriment of customers’ interests.”
- “Revenue sharing or other partnering arrangements with third parties.”
- “An incentive to favor products with higher commissions because these produce larger payouts. “
- “Churning practices, that may be motivated by a desire to move up in the compensation structure and, thereby, receive a higher payout percentage.”
- Biased “recommendations as a registered representative approaches the threshold necessary for admission to a firm recognition club (*e.g.*, a President’s Club or similar).”
- A temptation “to hire an associated person in spite of a poor regulatory history, if they believe that the individual can boost firm profitability.”
- “Incentive for the registered representative to recommend the fund that pays a [higher Gross Dealer Concession] to enhance his compensation.”
- “Conflicts, such as their role as a market maker; their trading in a principal capacity; the existence of multiple share classes of a recommended mutual fund; and their receipt of revenue sharing payments.”
- “Incentives for hiring personnel to fill a position with a potentially ethically compromised individual in order to meet a hiring target.”
- “FINRA remains concerned about the number of firms willing to hire associated persons with problematic disciplinary histories.”
- “The increased sale of complex products to retail investors who may struggle to understand the features, risks and conflicts associated with these products.”
- “Loosening controls… may exist around a product’s distribution, or incrementally changing existing product features to make the product available to a broader range of investors.”
- “Conflicts arise where a manufacturer or its affiliates play multiple roles in determining a product’s economic outcome.”
- “An index calculation agent may have discretion in how it calculates the value of an index it uses in a complex product, including, potentially, the authority to change the calculation methodology.”
- “The funds for which a firm receives revenue-sharing payments often will be placed on a ‘preferred’ list of funds the firm offers.”
- “Proprietary products and revenue sharing arrangements may involve significant financial incentives for firms to favor these products over others.”
- “Although registered representatives do not share in the revenue sharing payments directly, they still may favor funds on preferred lists, because of training the issuer provides or because the mechanics of order processing are, in some cases, easier for funds on the preferred list.”
- “When ‘the distributor basically acts as a “co-manufacturer’ [it] may have incentives to incorporate features such as high selling concessions or potential higher returns at the cost of a riskier product structure.”
- “A clear conflict would exist if a registered representative who is also registered as an investment adviser or advisory representative recommends that a customer purchase a mutual fund that is subject to a front-end sales load and, shortly thereafter, recommends that the customer move those mutual fund shares into an investment advisory account that is subject to an asset-based advisory fee.”
- “Key liquidity events [such as when an investor rolls over her pension or 401(k)] may heighten conflicts of interest because of the large sums of money that may be involved. …Firms have a strong

incentive to gather assets.”
- “[In a ‘net trade’], a market maker, after having received an order to buy a security, purchases the security from another broker-dealer or customer and then sells it to the customer at a different price.”

One person’s conflict-of-interest is another person’s synergy, and at least some of these synergies help make the financial services industry the wonderfully profitable business that it is. The conflicts are fundamental parts of a business model that a fiduciary standard would probably destroy.

Personally, I don’t favor a fiduciary standard for brokerage reps. It’s well intended but, under the timid (or radical, depending on your view) proposal currently on the table, unenforceable. It puts an unfair burden on sales people who are mostly trying to make a living, not practice a profession. Only the self-employed can readily exercise the discretion that fiduciary behavior demands. Buyers simply need to be reminded that when they enter a brokerage, they should beware.