

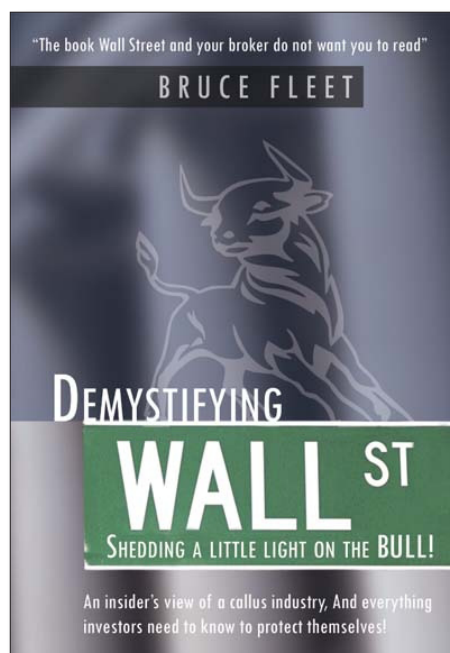
Brokers vs. Investors: The Roots of the Conflict

After 20 years on Wall Street, Bruce Fleet exposes the conflict of interest in the brokerage industry in his book Demystifying Wall Street: Shedding a Little Light on the Bull! But the book is far more than a critique of the Street's dubious practices. Its primary goal is to educate investors on the rules of the game, their options, and the importance of money management, so that they get a fair deal on protecting their financial future.

Q: Would you explain the reason behind writing the book? Why do you focus on the brokerage industry?

A: The book originates from my own career and experience with Wall Street brokerage firms. I have been a broker and national trainer for some of the largest brokerage firms in the world for more than 20 years. So, I've spent a lot of time at the highest levels of the industry, and I didn't like what I saw. Many brokers agree with that statement, which is evidenced by the increasing number of professionals leaving that industry. They love managing money but they want to do it in a way, where integrity and ethics are at the forefront.

The primary goal of the book is to educate investors and to provoke a national dialogue that, eventually, will have an impact on the business model of the brokerage industry. The necessary change is removing the commissions completely and entirely out of the financial management arena. Under the current business model, the compensation is based on generating commissions, and the result is an inherent conflict of interest between the advisor and client, and there is no way around it.



After all, the dialogue is about the most important bundle of money in their entire life. It could be the money for retirement from lifelong savings but, regardless of the source, it has to last with the investor's family. The management of this money is of critical importance, but it is turned over to someone who generates a commission on it. That doesn't make any sense.

Q: Could you explain the faults in the business model of the brokerage industry? Where exactly the

inherent conflict of interest is?

A: The advisor, or the broker, is entrusted with picking the best investments on behalf of the client. That's what the client expects and that's the nature of the relationship. However, for the client's portfolio, the broker selects among products that pay different commission rates, or different amount of dollars in his or her pocket. So, is it possible that the broker chooses a less appropriate investment, but one that pays him a greater commission? The answer is yes, and that's the conflict of interest.

Beyond that, there is even greater pressure on the broker to produce higher and higher levels of commissions. The brokerage firms base the worth of the broker on the amount of commission revenue generated. Every reward in the industry is based on the commissions - not only the broker's income, but also the size and the location of their office, the quality of their support staff, the benefits like free trips

And the dollars deposited into the broker's personal account based on the commissions are not some small incentive, but hundreds of thousands of dollars per year that the broker can receive.

“The pressure comes from the idea that everything good in the brokers’ life comes from the commissions they generate. At the same time, the client still believes that he can trust the broker, who is only going to recommend investments in the client’s best interest.”

And yes, it is a big deal, and that’s what nurtures the conflict of interest. All the Wall Street firms, UBS, Smith Barney, Merrill Lynch, A.G. Edwards, are the same in that respect. They all offer spectacular bonuses, trips, and rewards for the money the broker makes for the firm, not for the client.

But I don’t condemn the brokers because they do the best they can within that business model. Most of them would agree that, more often than not, they hope that the best interest of the client is achieved, while the best interest of the broker is certainly achieved. The majority of Wall Street brokers are highly educated and qualified, and with good integrity. But they, too, have to make a living and take care of their families. Also, they get used to a certain way of life, which pressures them to generate more and more commissions.

The bottom line is that the motivation of the broker and the client are very different and completely misaligned, while there should be symmetry between those two motivations. The commissions should be eliminated from the industry. That has already been done in the field of the Registered Investment Advisors, or RIAs, but that’s probably the smallest segment of the financial advice industry. Thousands of brokers, who have been in the business for 20 or 30 years, and are now moving to the RIA side.

Q: How does the RIA model differ from that of the brokerage firms?

A: RIAs are typically people who have been in the business for a long time, but have left the Wall Street brokerage firms because they were disgusted with the business model. An RIA holds a much higher fiduciary responsibility and cannot receive a commission by law. I am one of those people, and we work based on fees only.

An RIA only gets paid a fee, or percentage, which is based on the value of the

assets he manages. Therefore, the advisor is motivated to grow the client’s money on the upside, or to preserve it during difficult markets. The only revenue of the professional advisor is the ongoing stream based on the size of the assets, and it doesn’t matter what investment products they use. So, there’s no financial conflict of interest.

If you’re a commission person, you have to sell to generate a commission. If you’re a RIA, you don’t sell anything, you’re just managing, and those are very different concepts. The only way the revenue goes up, is efficiently growing the assets under management by proper investment selection. Conversely, if you’re not very good at picking investments, the portfolios will go down, and your revenue will go down. So, the RIA business model is conflict-free when it comes to selecting investments, because the selection is based purely on how well the investments will perform in the clients’ account.

Q: Doesn’t that argument refer to the brokerage industry as well? If the broker isn’t making money for the client, the client will leave, and he will not receive the commissions any way. It makes a sense for the broker to make money for his clients, does it?

A: That’s a very good point, and it brings us back to the education of the client. Most of the clients that I interviewed had no idea that there exists another way to pay for investment advice. Let’s say a client with Merrill Lynch, for example, loses money and is very unhappy with the broker. What they would do is transfer the account to Smith Barney, or UBS, or any other Wall Street firm. In the end, they are replacing one broker with another.

Based on talking to clients around the country, I strongly believe that if the clients knew that they had a conflict-free alternative, they would opt for it.

The major brokerage firms spend huge money on advertising each year, while the RIAs don't advertise at all. They are much smaller firms, with smaller clienteles, where there is a boutique-style one-on-one relationship.

I am not saying that investors should not do business with brokerage firms. However, if they place their hard-earned savings with a commission-based model, they need to be well educated. They should know how the game is played; they should understand the industry motivation, and be more proactive in understanding how their money is managed. I am not advertising the RIA model and, actually, a very small part of the book is devoted to it. The idea of the book is to help investors make an educated choice.

Q: What is the size of the two industries in terms of number of brokers vs. RIAs?

A: My understanding is that there are 600,000 registered, commissioned brokers in the United States, of which about 120,000 are active. For comparison, the RIAs in the fee-only area, are 10,000 to 12,000, or 10% of the overall financial services industry. That means that the investor has a 90% chance of bumping into someone who charges commissions. Moreover, it is the commission-based side that spends the money on advertising, so the investor doesn't even know that the other 10% of the industry exists.

Q: What are the major problems in the structure of the brokerage industry? How can those be corrected?

A: The overriding problem is the compensation paid to brokers, but it extends to the branch and the national level. The branch manager is typically compensated based on the performance of the brokers, so the financial pressure extends to the supervisor as well. The branch managers are people with signif-

icant incomes, ranging from \$600,000 to \$2 million per year but, just like the brokers, they can maintain their lifestyle only through keeping up the commissions. So, the brokers get pressure from their manager and from the corporate office, which controls the huge bonuses received at the end of the year. As a result, there is a lot of pressure on the brokers.

At the national level, Wall Street very rapidly creates investment products that respond to the emotions of investors, because they always need something to sell to investors. Clearly, there are brilliant people on Wall Street, who well understand that individual investors are driven either by fear or by greed. So, when the market is going down and people start to panic, just like a machine Wall Street creates investment products that sound very safe.

The products promise protection, yet they may or may not be the right investment for the client. The certain thing is that the investor will buy it on the advice, and the broker will receive a commission. So, much of the product creation is also related to the need to generate commissions. At the same time, the buyers don't have the level of education in finance to understand that they're being taken advantage of.

It really doesn't matter how many different layers you analyze - national, regional, statewide, or a specific office - the conflict of interest is consistently there.

Q: How is that relevant to the merits of the product sold to the potential investor? Both the brokers and the RIAs would be selling the product and can be unable to determine its merits.

A: The difference is that a RIA is not looking for new products to place in a client's portfolio to generate a commission. Therefore, the RIAs are less



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Fleet's new book, *Demystifying Wall Street* is available everywhere, as well as through his web site www.brucefleet.com.

inclined to buy the product of the day, if they are not convinced in its merits. Often, they don't even hear about these products because they're not with major brokerage firms. RIA companies like Schwab Institutional, Fidelity, or Pershing, just do the custody and the back office work; they never send product information to the RIAs. It's just a different business model.

Q: Let's take the example of the ETFs, which came out 10 years ago, and became very useful because of their low cost and wider diversification. Who is more likely to recommend this product - the RIA, who has no benefit from it, or the broker?

A: That's a great question. We both agree that the ETFs are very good products for the right investors because of the significantly lower costs and the tax advantages. But exactly because of the very low fees to the investors, the ETFs can't pay big commissions to a broker. So, which advisor is more likely to use that product - the broker who will be paid next to nothing, or the RIA, who has no commission involved in the process? My point is that investors have a better chance to be presented with high-quality product that meets their needs through someone who isn't driven by commissions.

In another example, I would use the Vanguard Funds, which are very low-cost index funds. Their creators believe that expenses matter and want to keep them as low as possible. Therefore, they generally don't do revenue sharing with the brokerage firms, and may not be included on the brokerage platforms. The result is that these funds may not even be an investment that the broker can choose from, while some of them are really high-quality firms.

Q: Does making one poor product make you a poor company? For example, if Ford Motor Company,

occasionally makes a less safe model, that still doesn't make Ford an inherently bad car maker. Ford would lose market share and be punished financially by the market forces.

A: Auto manufactures, like Ford could be compared to investment companies like Fidelity, Putnam, or Oppenheimer Funds. If a mutual fund company makes an inferior investment product, similarly, if a car manufacture makes a poor quality car, it may lose market share. My argument is not with the creator of the investment product, it's with the commission based salesman. I am criticizing the brokerage firm level, where they are just selling, regardless of the quality of the underlying product.

Nevertheless, the analogy between Merrill Lynch and a car dealership is very good. If a Ford dealership sells poor quality cars, all the client has to do is read the Consumer Reports, and he will find out about the dealership down the street selling Toyotas. And the purchase of a car doesn't change your life.

At the same time, a financial broker is dealing with your life savings and I believe that the broker should be held to a much higher responsibility. It is not just a car; it is a much more important life situation. And, yet, people typically study the purchase of a car or a refrigerator longer than they study the purchase of their financial advisor or product. They make this decision after a phone call or after reading an article in Money magazine. To me, that's absolute foolishness.


Q: I couldn't agree more about the lack of education and comprehensive information on third parties, like advisors and brokers. In your view, who should be the referee? What is the solution?

A: I believe that through eliminating the commissions, we shall eliminate 90% of the conflict of interest. Also, I make

clear in the book that this is not only a problem of the brokerage firms, but also a problem of the investor. Investors don't take responsibility for their money and don't learn enough before making some of the most critical decisions of their lives. They just place the understanding and the power in someone, who is earning a commission on their money.

The readers of *Ticker Magazine*, 123Jump.com, and other publications are taking the initiative to learn, and I applaud them. Most people don't do that. To be aware of the opportunities out there, investors need to be educated. The investors can also start asking their brokers the right questions, some of which I have suggested in the book.

Some people have a wonderful long-term relationship with a commission-based broker, and I don't want to break that, but they should at least be able to ask the right questions about their money.

Overall, I am trying to explain the basic rules, concepts, and options, but the investors are responsible for their decisions. The message is to know that you have different choices and to realize the critical importance of managing your money. You cannot afford to play games because you work your entire life to save for retirement. If you give it to the wrong person, you cannot start all over when you are 70 years old. 

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