Why your stockbroker doesn't really work for you

SAVAGE TRUTH | Financial salespeople should all be held to same high standard

March 22, 2010
BY TERRY SAVAGE

What's the most significant difference between a stockbroker and an investment adviser?

If you're like most investors, you'll find it difficult to make that distinction. In fact, you probably consider your broker to be your adviser when it comes to investments. But there is a huge distinction between the two categories of broker and adviser -- a difference that could be very costly.

Let me start by saying that the ultimate distinction is the character of the person with whom you choose to work. No matter what the title, the most critical ingredients in this decision revolve around expertise, experience, and integrity.

That said, there is a legal difference between the obligations of a stockbroker or "registered representative" and a registered investment adviser.

Distinct difference

The investment adviser pledges to put his or her client's interests first. That would require full disclosure of all costs and commissions, as well as any potential conflicts of interest. It's a standard set by the Investment Advisers Act of 1940 and affirmed by the Supreme Court. It's called a "fiduciary duty."

But stockbrokers are only required by rule to "know your customer" and to offer products that are "suitable." Brokers have been excluded from the fiduciary duties required of investment advisers as long as any advice they give is "solely incidental" to their brokerage services.

That's a huge distinction -- and one that is little recognized by most investors, who naively assume the "expert" they are consulting is required to be their advocate.

• Those distinctions were made long before there were "wrap accounts" and "managed accounts" sold by brokers.

• And those lines were drawn when insurance companies offered few, if any, investment-type accounts such as tax-deferred annuities or universal life policies that include investment alternatives.

• The rules were created long before you could walk into a bank, expecting to buy an FDIC-insured certificate of deposit, and instead find yourself in the "investment department" being talked into a bond fund or annuity.

• Those rules were outlined before the blurring of titles for salespeople for all of those products.

No wonder there's confusion among investors and savers about finding advice they can trust. The laws do not require salespeople to put your best interests ahead of their own financial interest.

Changing the fiduciary law

Now a group of highly respected economists, investment advisers, financial planners, and journalists (myself included) are publicly calling for the proposed financial reform legislation to require the fiduciary standard to be applied to all who provide financial advice.

John C. Bogle, founder of the Vanguard Group and a signer on the petition, says Congress needs to act to affirm the basic principle that when rendering investment advice, "No man can serve two masters."

There's a provision in the financial reform legislation introduced last week by Sen. Chris Dodd (D-Conn.). It would require a study about the benefits of extending the fiduciary standard to stockbrokers.

It seems to me that very little study is required. Asking brokers to adhere to the highest standards of responsibility is hardly an issue that should raise debate. In fact, most brokers agree this is a good idea. It's the Wall Street firms and the insurance industry that seem to be dragging their feet.

Think about it. If brokers are required to put their clients' interest ahead of their own, they'd be selling no-load or index funds. Insurance salespeople couldn't sell annuities that are loaded with fees, commissions, and penalties without full disclosure -- and counseling their prospects on lower-cost, similar alternatives.

The new awareness would increase product competition -- and bring down profit margins. That's hardly a revolutionary idea, nor is it one that should really threaten the Street.

Thirty five years ago, Wall Street deregulated brokerage commissions in an emotional event that was called "May Day" not only because it occurred on May 1, 1975. The competition that ensued certainly didn't drive the best firms out of business, as many had predicted.

More recently we've seen full disclosure of everything from new car costs to airline fares, and the intense competition raised by full disclosure has brought on new winners, like Southwest Airlines. But in every case, consumers have benefitted by full disclosure -- a basic premise of the fiduciary standard.

In these days of general public disillusion with Wall Street, any idea that encourages the public to feel their financial brokers are on their side is an idea that should be trumpeted instead of buried in a "study."

We need faith in the free markets to bring our economy back into growth mode -- the only way to provide jobs and all the government benefits we have promised. And we need investors in our markets to benefit from that growth and provide capital for future development.

It's time for all financial salespeople to adhere to a fiduciary standard. If we keep operating on a "buyer beware" standard, then don't be surprised if wary buyers avoid the markets entirely. And that's The Savage Truth.

Terry Savage is a registered investment adviser and a co-host of "Monsters and Money in the Morning" on WBBM-Channel 2 from 5 to 7 a.m. weekdays.