The Mad Hatters of Wall Street

Summer 2010

What the Goldman Sachs Case Means for Ordinary Investors

Summary

While Goldman Sachs executives utter nonsense at Senate Committee hearings, what investors really need to know about their risk of being subject to the various games going on in the banking industry is this: does the person I go to for financial advice have an obligation to place my interests before their own? The Goldman Sachs' case offers some interesting touchstones for answering that question.

’Twas brillig, and the slithy toves,
Did gyre and gimble in the wabe:
All mimsy were the borogoves,
And the mome raths outgrabe.

—Lewis Carroll
Through the Looking-Glass, and What Alice Found There

Don’t be concerned if the April 27 testimony of Goldman Sachs’ top executives before the Senate Committee on Investigations sounded like Jabberwocky. Because it was. The committee was inquiring about the 2007 Abacus transaction in which two European banks lost around $1 billion. Goldman has been sued civilly for fraud in the transaction by the SEC.

Senators repeatedly asked whether Goldman was required to act in the best interests of its clients. Following are some of the executives’ responses.

- “I was an intermediary between highly sophisticated professional investors.”
- “I believe we have a duty to do well for our clients.”
- “We have a duty to show prices and provide liquidity.”
- “I don’t believe we act as investment advisers to our clients.”

Of course, in November, Goldman CEO Lloyd Blankfein also indicated that he was just a banker doing God’s work.

How are these executive’s able to sidestep the questions with such mumbo-jumbo? Currently, the rules governing what broker/dealers are required to do for their clients as opposed to what investment advisors must do make it possible for a firm like Goldman Sachs to do exactly that: be vague. As a result, this case serves as an ideal jumping off point for examining the dilemma faced by the average investor—even if your broker may not be likely to sell you an investment designed to blow up.

Whose Hand is in the Cookie Jar?

In the Abacus transaction, Goldman created a *synthetic* collateralized debt obligation (CDO). (An actual CDO is a package of mortgage securities, grouped in tranches according to their risk and purchased by investors. Synthetic CDO’s became prevalent at the end of the housing bubble because insa-

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tiable demand for the real ones caused them to be out of stock; but investors still wanted to make bets on the housing market.)

The Abacus security—a derivative—made reference to several dozens of actual mortgage pools and was simply a wager on the housing market by the two parties to the transaction. The buyers (Royal Bank of Scotland and IKB Deutsche) received a premium, reported to be $15 million, from the seller (hedge fund Paulson & Co.) in exchange for a promise of payment to the seller if the value of the referenced mortgages would fall. Subsequently, when the housing market collapsed, the underlying mortgages became worthless and the banks had to pay Paulson $1 billion.

The fraud charges arose because Goldman is alleged by the SEC to have represented in the offering document that the referenced securities were selected by an independent expert—ACA—when Paulson (who was on the short side and wanted the investment to fail) actually had a hand in choosing them. Whether or not that rises to the level of actionable fraud remains to be seen.

The Sophisticated Investor

Goldman has defended its "market making" activities, in which it manages transactions between sophisticated customers (or itself as a principal) as being essential to the functioning of the capital markets. Disclosure and other ethical requirements for banks and brokers unquestionably are lower for transactions in which the parties have the resources and expectation of fending for themselves.

So long as these transactions don't pose systemic risk to the financial system—an entirely separate question inasmuch as both banks had to be bailed out by their respective governments—they can be viewed as activities between consenting adults in the privacy of their own board rooms. (Of course, the clients, depositors, customers, and beneficiaries of these so-called sophisticated investors might be concerned about what kinds of risks are being taken by MBA whiz-kids on their behalf.)

Suitability Standard vs. Fiduciary Duty

For most of us, the key is to understand the legal and regulatory relationships between Wall Street firms and their customers/clients—depending on which of the variety of hats they wear—and how that affects the experience of the ordinary investor.

Financial services firms and their representatives are generally registered either as a Broker/Dealer under the Securities Exchange Act of 1934 or as an investment advisor under the Investment Advisors Act of 1940—or both. Additionally, some financial products are sold by licensed insurance agents.

Broker/dealers and their representatives (by rule promulgated by FINRA, the regulatory organization that oversees them) may recommend products and investments to their customers based solely upon a determination that a given product is "suitable" for the client in question. On the other hand, investment advisors and their representatives have a statutory fiduciary duty to act in their clients' best interest.

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Suitability

Brokers do have a duty to ascertain basic information about a customer's financial and tax status as well as her investment objectives. Further, customers must have adequate means and liquid assets to assume the risk of loss from a security sold to them. Beyond that, it is *caveat emptor*: after the sale, the broker has no ongoing duty to monitor the investment.

Moreover, a broker need not be concerned with the costs imbedded in a product, its tax efficiency, or the fees being charged. It is perfectly legal for a broker to recommend a product from a set of choices that is otherwise suitable, based entirely on the level of compensation flowing to the broker or the firm. In addition, brokers may engage in principal transactions with their clients; that is selling products out of their own inventory and marking them up to make a profit.

Fiduciary Duty

By contrast to rules governing brokers, a Registered Investment Advisor's fiduciary obligation to his client is among the highest accorded under the law. Emanating from centuries of trust law, he has the duty of due care, loyalty and utmost good faith. He must act for his client, alone. Avoidable conflicts of interest must be avoided and unavoidable conflicts must be disclosed and managed. All compensation must be disclosed and agreed upon in advance. Advisors have an incentive to purchase on behalf of their clients the lowest cost option of equally suitable choices. As a fiduciary, these advisors must act with the prudence, skill, care, and good judgment of a professional—which is why RightPath Investments is structured as a Registered Investment Advisor.

If a broker provides investment advice beyond that which is "solely incidental" to the sale of a product, he is supposed to be registered under the '40 Act and adhere to a fiduciary standard of conduct. This requirement is honored more in the exception than the rule. Occasionally, a broker will acquire fiduciary status through state common law by taking on a special relationship with a customer, or acting with discretion over a customer's account. In their marketing materials, Wall Street firms generally describe themselves as advisors or consultants and often proclaim that their clients' interests come first. In claims for damages against brokerage firms, customers' attorneys often assert fiduciary type claims; but it is nearly impossible to know how often brokers are actually held to a fiduciary standard because disputes between brokers and customers are subject to mandatory arbitration and arbitrators do not generally provide the reasons for their decisions.

Incidentally, the Certified Financial Planner® Board of Standards recently amended its rules of Conduct (Rule 1.4) specifically to require of its certificants *"to at all times place the interest of the client ahead of his or her own. When the certificant provides financial planning or material elements of financial planning, the certificant owes to the client the duty of care of a fiduciary as defined by CFP Board."*

Prospects for Regulatory Reform

It is easy to paint on this particular canvas with a broad brush. There are hundreds of thousands of broker/dealer representatives in this country working for dozens of firms—over 20,000 at what used to be Merrill Lynch (now part of Bank of America) alone. Most of them want to do right by their customers, many of whom are relatives and friends who have done business with the broker for years. Others

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want to have it both ways and act as fiduciaries for those customers who have caught on, but still sell questionable products to those who remain naïve. And, no matter what the rules, outright fraud, such as a Ponzi scheme, remains possible if investors do not take basic precautions on their own.

Manifestations of brokers taking advantage of their customers have been known to regulators, Congress, and investor advocates for decades. Different products have their seasons: tax abusive limited partnerships in the '80s, overpriced and over-hyped IPO's in the '90s, supposedly safe Auction Rate Securities in the 2000s and the product *du jour*—variable annuities, with their high commissions and surrender charges, layers of hidden expenses, and "benefits" of dubious value.

In response to the Great Recession of 2008, the House and Senate have each passed financial regulatory reform legislation to address the conditions that contributed to the economic disaster. But the bills address the fiduciary standard in different ways and must be reconciled by a conference committee before being sent to the President for his signature.

The Senate bill requires the SEC to complete a study (the SEC conducted such a study in 2007) on the issue and report back to Congress. The House bill gives the SEC authority to extend the fiduciary standard to broker-dealers who provide investment advice. It is not clear which version, if either, will prevail; or, if one of the several proposed amendments that would adopt the fiduciary standard directly in the legislation will be inserted at the last minute.

Among the organizations pushing for reform are: the Financial Planning Association (FPA), The Financial Planning Coalition (comprising the FPA, the CFP Board of Standards, and the National Association of Personal Financial Advisors), the Committee for the Fiduciary Standard, the SEC Investor Advisory Committee, and the Consumer Federation of America.

Brokers and insurance companies continue to lobby for anything but the high standard imposed upon advisors under the '40 Act. FINRA is opposed to raising standards for broker-dealers and seems to be in favor of a watered down fiduciary standard applicable to both brokers and advisors.

Fiduciary responsibility would demand brokerage firms to drastically change their cultures and business models. One securities analyst estimated that if the fiduciary standard were extended to brokers providing investment advice it would cost large firms like Morgan Stanley Smith Barney (which earns annual net revenues of $14 billion) and others as much as $300 million per year in profits—only 2% of revenues, but enough for such entities to put up a good fight.

The fireworks should be over by the 4th of July.

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