Death By Suit-ability?

Frederick Rosenberg

© 2008 Frederick Rosenberg

Overview

There's an old story about a country boy who traveled to the big city to buy his first suit to wear at his wedding. As fate would have it, he wandered into a men's store in a somewhat depressed area of town. The salesman, seeing an opportunity to move some dead inventory, measured the farmboy before handing him a garment to try on. "I've got just the thing for you," he said, handing the country boy a suit.

When the country boy complained that the right sleeve was way too short, the salesman explained that the sleeve was proper length and that all he needed to do was adjust his posture by lowering his left shoulder. Doing so caused the left sleeve to extend way beyond the boy's fingertips. When he again complained, the salesman insisted that the problem was with his posture and advised him to crook and extend his left elbow. With his right shoulder down and his left arm bent, a huge bulge popped up over the collar. Once again, the salesman attributed the improper fit to a posture problem and advised the boy to bend at the waist and twist a bit to his right. "Perfect!" the Salesman said.

The country boy paid for the suit and exited the store in his new duds, heading for the church, when he came across a young mother with her child. Upon seeing the young man the child turned to her mother and said, "Oh mama, look at that poor crippled man!" Whereupon the mother replied, "I see darling, but look how nicely his suit fits!"[1]

An *Uneducated* Consumer is our Best Customer.[2]

The securities analogy is palpable. Instead of tailoring the portfolio to the customer, too often it is the customer who is tailored to the portfolio, inveigled by advisers into

---

[1] *Two years later*: In an arbitration brought by the country boy, the salesman argued 1) that his men's shop had four full-length mirrors and if the Claimant were really dissatisfied he surely did not complain, 2) that people buy clothes that don't fit all the time, only to suffer buyer's remorse, 3) that the suit actually fit so long as the Claimant would contort himself to wear it, something he agreed to do during the fitting, and 4) the Claimant actually appears in a photograph at a movie theater showing "The Hunchback of Notre Dame" and admits to having a full length poster of Charles Laughton in his bedroom. The Panel dismissed the claim.

[2] See *Syms*, A play on the advertising slogan of Syms, a well-known New York metropolitan clothes store, "An Educated Consumer is our Best Customer.

strategies and investments that often are incapable of achieving objectives without extreme short-term risk. Virtually every recommendation, good or bad, is pitched and sold as a risk-appropriate strategy to achieve a customer's objective; rarely are they accidental. To the contrary, most disastrous recommendations are intentional, often based upon market-rationalized beliefs that equities and equity products can be configured to achieve every "objective" for every investor when in fact such customers should be advised that if the suit doesn't fit, don't buy it.

Learned Profession, Not!

The Department of Labor defines the term *Learned Professional*[3] as follows:

> To qualify for the learned professional exemption, an employee's primary duty must be the performance of work requiring advanced knowledge in a field of science or learning customarily acquired by a prolonged course of specialized intellectual instruction.

This *primary duty test* includes three elements:

1. The employee must perform work requiring advanced knowledge;
2. The advanced knowledge must be in a field of science or learning; and
3. The advanced knowledge must be customarily acquired by a prolonged course of specialized intellectual instruction.

Despite the wide spread industry hyperbole claiming professional status essentially for salesmen who've mastered relatively simple concepts of selling retail investment products to the public and who've passed the Series 7

[3] 29CFR 541.301

or Series 65 exams, *Registered Representative and RIA are not Learned Professions.* Neither is a Certified Financial Planning certificate the equivalent of an MBA or Chartered Financial Analyst designation.

The Sales Environment

Financial advisers and brokerage firms do not make their money by buying, holding, or trading stocks for their own account as they advise their customers to do. They make their money by getting their customers to buy, hold or trade securities and then charging fees or commissions. Often, brokers promise returns that exceed even the growth rates and profitability of their own firms, ironically suggesting that the brokerage firm would be better off closing its sales offices and following its own recommendations.

Registered Representatives are salesmen specifically hired and trained to sell commission or fee-based products and services. They work in sales offices and survive if their gross commissions rank at or above a defined threshold. They are screened for their social skills, selling skills, access to clients, and perhaps their score on the [sic]"Greed Index", not by the cogency of their MBA dissertations, and certainly not by the performance of their recommendations.

Furthermore, the retail brokerage office is a high stress, highly competitive, income-driven environment. Higher gross commissions result in higher payout, a better desk location, an individual office, a more impressive title, an occasional trip, award or promotion and possibly an override. Every month each representative is ranked among peers by several sales metrics and those at the bottom are likely out the door.

Ask any branch manager about an individual broker and [s]he'll discuss the rep's gross commissions, office rankings, product breakdown (options, mutual funds, equities etc.), and even social skills. But, ask the branch manager how a certain representative's clients are faring, or better still, ask the branch manager to rank representatives by the market performance of their recommendations and you'll realize that firms maintain no metrics to determine the answer. Instead you'll often get guesstimates or market-related

answers such as “the customers must be happy because no one’s complained”, or “the rep does a significant gross”.

Ratification of Abuse

Based upon recent awards, one might conclude there’s a safe-harbor in arbitration for abuses committed against smart, experienced, or successful customers. If the broker has erred however, it should matter not a whit whether the customer is affluent or destitute, brilliant or half-witted, intuitive or dense, or even whether the customer agreed in good faith to the proposed strategy.

Furthermore, a customer cannot consent to fraud, and nothing that a customer does, is, signs, or agrees to can exonerate or ratify securities abuse. Neither can customers be held to the standards and experience of the supervisory people mandated to oversee their account and adviser. Agreeing to an adviser’s recommendation does not presume contributory negligence, nor does it exonerate conduct that is actionable, and still, you’d be hard-pressed to conclude as much from arbitrator awards that deny recovery to claimants 55% of the time.

Many of my colleagues treat an unsuitable portfolio as a cause instead of a consequence of action. But, conflating unsuitability with negligence focuses attention only on what is self-evident, the losses, yet fails to explain to panels why recovery is justified. Inevitably the customer endures a withering cross-examination berating his spending habits and failures while declaiming his complicity in disaster simply for following the advice of his adviser.

Sadly, despite the fact that volatility is predictable and quantifiable, arbitration panels have often proven loath to hold brokers responsible for losses attributable to the “unpredictable” direction of the markets. As they say, “It ain’t the insurance business.”

Arbitration panels typically rule against claimants when claimant’s counsel ignores causality to harangue about “unsuitable” portfolios. In point of fact, suitability

counts only reinforce a "means test" or "sophistication threshold" as a predicate for recovery for broker misconduct. In any other area of consumer litigation, an aggrieved customer's education, sophistication, or use of the product is not a barrier to recovery. Yet in securities arbitration, the Claimant is cross-examined relentlessly as if by agreement he or she were actually responsible for the recommendations. Can we really be surprised after Claimant's counsel argues passionately that his client has been "financially contorted", that arbitration panels' response has often been the equivalent of "Yes, but look how nicely his suit fits."

What's the Risk?

Every time I board an airplane, I take a risk; it's the same when I cross the street. In San Francisco there's a risk of an earthquake. There's a risk of death even when having a tooth filled under nitrous. Still, I'm willing to cross the street to catch a cab to the airport and fly round trip to San Francisco to get a root canal from my brother-in-law without a bit of concern for the collective risks. Succinctly stated, it is not the possibility but the probability of disaster that controls my decisions.

Customers hire full service brokers, planners, or advisers to reduce the probability not the possibility of disaster. Most aggrieved customers however are simply ill-equipped to disagree with adviser enthusiasm for equities and long-term growth. Unfortunately, most customers rarely understand their adviser's limitations in controlling risk. They do not understand rebalancing, or the impact of their adviser's stay-the-course strategy in periods of high volatility, or the corrosive impact of fees and costs over the long-term.

Importantly, most investors have little or no understanding of conflicts of interest that in any other learned profession would be unethical without complete disclosure. They do not understand the conflicts of interest and biases that motivate advisers to commit excessive dollars to "long-term growth" strategies utilizing high volatility equities and equity funds, and they do not understand their need for the advice of qualified counsel before signing agreements surrendering control of their life savings to a

commission or fee driven adviser. As with any product, small font disclaimers are obscured by boldface promises!

Many advisers erroneously conflate money management with financial planning, but financial planning and money management are not synonymous. "Money management" is a recognized skill-set entirely different from Financial Planning. The CFP Board of Standards clearly distinguishes planners from "money managers" who actively manage portfolios on a *discretionary* basis[4]. While a financial plan may need revision once every 3 to 5 years, active management requires hands-on attention every day the market is open.

In general, financial advisers fall into four broad and occasionally overlapping categories, 1) registered representative, 2) financial planner, 3) money manager, and 4) registered investment adviser, (RIA).

Money managers actively manage assets day-to-day under discretion and pursuant to well-defined strategies and objectives. Their model performance is measured against identified correlated indices. Most money managers limit their energies to managing no more than 3 or 4 investment portfolios. Money managers generally have limited contact with retail customers except to explain their investment strategies and track record and most rely on adviser referrals and fee splitting to bring money into their investment control.

Maintaining recommended portfolio allocations is the minimum expected from a money manager. Portfolio allocations inevitably shift from original recommendations and the manager owes a duty either to correct the imbalance or communicate to the Client the reasons why the imbalance is now consistent with the original investment objectives.

Financial planners design portfolios based upon a client's financial profile, and review and report on the portfolio at periodic intervals. Financial planners rarely if ever

---

[4] The CFP Board of Standards defines a Money Manager : "Money managers typically design a portfolio for clients (or work with a design developed by a financial planner) comprising individual securities, bonds, real estate or other financial assets and investments, and manage the portfolio on a discretionary basis, usually for a fee that is a small percentage of the value of the assets under management...."

take discretion and with dozens if not hundreds of clients they often have little time or ability to respond to daily market volatility or portfolio allocation shifts on a client-by-client basis. Financial planning, including the sending of regular statements, conducting periodic reviews, and adviser availability to answer customer questions in itself does not rise to the level of management, which is precisely why it is called financial planning and not portfolio management. In fact, apart from periodically producing a financial plan, a financial planner's responsibilities are virtually identical to those of ordinary stock brokers who aggressively disclaim managerial responsibility.

Registered representatives execute trades and may recommend securities approved by the firm when asked, but have little affirmative obligation to advise or manage at all.

Registered Investment Advisers, (RIA), usually specialize either in active management, or financial planning, but rarely can they do both. Registered Investment Adviser licensure authorizes asset-based fees for RIAs without requiring any supervision by a broker/dealer. The trade-off for RIAs is that they assume the fiduciary risk and take on defined legal duties to the customer well beyond the responsibilities of a simple stockbroker[5].

The principal duty owed by fiduciaries is the duty of loyalty, meaning that the interests of the client must always be put ahead of the adviser's. This duty of loyalty requires complete and full disclosure of conflicts of interest, disclosures typically lacking in cases of securities abuse. Ideally, clients want an adviser who'll be responsible for designing and actively managing individualized portfolios, but such an adviser is nearly impossible to find.

---

[5] Chief Judge Benjamin Cardozo of the Court of Appeals of the State of New York, in an often quoted passage from his opinion in *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545, 546 (1928), pertaining to a fiduciary's duty of loyalty . "Many forms of conduct permissible in a workaday world for those acting at arm's-length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the **morals of the market place**. … Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd."

A Brief Digression into History

In the mid-1970s when I was a broker with a large wire house, not one client ever had more than 10%-20% of their liquid assets in the stock market. On average, less than six million shares traded daily on the New York Stock Exchange. Margin requirements were 70%. Affluent clients invested in bonds for safety. Most importantly, average workers and employees of large corporations were generally covered by defined benefit plans that assured a lifetime pension at retirement in addition to social security.

For better or worse, in the late 1980s through the 1990s defined benefit plans were supplanted by defined contribution plans, like 401Ks, and suddenly people, who never before had been investors, were solely responsible for their investments and financial planning, something they were ill-equipped to understand. With limited alternatives for their money, billions of dollars flowed into the market from inexperienced investors seduced by the financial industry's love affair with and enthusiasm for technology and growth.

Despite "irrational exuberance" in the markets, Alan Greenspan's Federal Reserve dropped interest rates to historic lows further driving the market higher. Corporate consolidations left hundreds of thousands employees with lump-sum buy-outs targeted by their advisers for stock market investments, virtually the only marketplace capable of absorbing the influx of new money. Over the decade, the mutual fund industry and financial planning industry exploded.

Furthermore, executive compensation, driven by quarterly earnings and stock performance, fueled the fraudulent accounting scandals that led to the demise of Arthur Anderson & Co., Enron and Worldcom . Technology, which fueled the market bubble of the late 1990s, also enabled program trading, which contributed to sudden market corrections on more than one occasion. NYSE trading alone went from six million shares

per day to two billion shares per day in 25 years, while 24/7 financial networks abounded on every cable or satellite system. During the late 1990s and early 2000s, market-cap weighted indexes like the S&P 500 saw their Standard Deviation increase by 140% from 15% to 21%, a rate normally considered highly aggressive, evidencing the considerable increased volatility even for clients advised to stay the course.

Finally, in the last two decades there has been a dramatic shift by corporations away from long-term, disciplined borrowing via debentures to equity financing that unburdened balance sheets from the debt and debt-covenants that hamstring public corporation during periods of stagnant or negative growth.

It is gross simplification to represent that the markets' risk in the 2000s can be measured by historical metrics. Over the last 15 years, the primary factors affecting the market prices of stocks have been driven primarily by short-term expectation, not long-term trends, as was the case through most of the last century. Furthermore, the financial industry well understands the catastrophic consequence of retail investors exiting the stock market *en mass*, leaving the institutions and mutual funds holding the bag. Consequently, investors have routinely been advised to stay the course even during periods of extreme short-term and quantifiable volatility. And without any non-market-based alternative strategies ever being proposed or recommended, retail investors have found themselves continually channeled into long-term equities whose market value can collapse by 10%-20% overnight based upon missing earning targets by a penny or two.

Death to Suitability

Whether investments are suitable or not is more a question of opinion than fact, which is why prevailing in arbitration has been so difficult. "Suitability" is a term of art in the securities lexicon, one that most clients are unable to quantify; volatility, however, can easily be measured and quantified. Customers typically get into trouble, not because their portfolio is unsuitable, but because 1) they fundamentally misunderstand risk(volatility) and their adviser's professed ability to intervene in time to reduce the probability of substantial loss, and 2) they're often pressed to make decisions in a sales

environment without the un-conflicted second opinion of knowledgeable and independent counsel.

To paraphrase the late New York Senator, Daniel Patrick Moynahan, from a debate on the floor of the US Senate: “Advisers are indeed entitled to their own opinion but they are not entitled to their own facts”. An adviser’s opinion about suitability does not alter the discernable risk metrics one iota. Rather than litigate whether or not the portfolio is “suitable” as the basis of recovery, attorneys are best to focus their claim on the sales environment and the representations, omissions, and presentation materials that induced customer agreement to the recommendations in the first place.

Most investors know instinctively that there is risk in market investments, which usually is their motivation to hire an adviser in the first place. What they do not understand is their probability of disaster, or that relying on long-term equities typically assures short-term volatility, or that the industry’s “stay the course” bias against market timing effectively means there is no effective strategy to control the impact of short term market gyrations on long-term equities, gyrations that are becoming a fixture in present day stock markets.

Conclusion

In conclusion, customers, often catastrophically, go unrepresented when signing over their assets to a fee-based or commission-compensated investment adviser, arguably one of the most important financial decisions they'll ever make. Ironically, the same clients are uniformly advised to obtain qualified counsel in every other financial dealing - from buying a house or getting a divorce to forming a business partnership or giving a loan. Rarely in fact, are customers ever advised to obtain an independent and un-conflicted second opinion on their adviser’s recommendations or on the binding agreements they’re asked to execute. This legal equation is simply out of balance.

The fact that an injured customer is persuaded to accept an adviser’s recommendations is usually the predictable outcome of a sales presentation that ignored

comprehensive risk disclosure, used half-truths or incomplete illustrations and overly simplified portfolio management in the present environment. Arguably, without full disclosure there can be no customer agreement, only customer manipulation or inducement fraud, which brings us full circle in this chapter. "A customer cannot consent to fraud, and nothing that a customer does, is, signs or agrees to can exonerate a financial adviser or ratify securities abuse." Hopefully, arbitrators are aware of that! If they aren't, it's your job to make sure they are.