Fixing Wall Street

A first step toward restoring customer trust in the system.

By Martin Mayer

More than half a century ago, Fred Schwed, Jr., who had survived the greatest of all financial market booms and busts, told the story of a tour bus of Nebraska farmers taken to downtown New York. The guide pointed out Trinity Church and the Morgan bank and the Stock Exchange, and waved at the docks in the East River at the foot of the hill. "There," he said, "you see the yachts of the great Wall Street brokers."

One of the farmers' children worked up his courage to ask a question: "But where," he said, "are the customers' yachts?"

It is no surprise that the operators of the casino can make money when the players don't. One of the most-trusted short-term market indicators is the put/call ratio in the options exchanges, where individual customers play a larger role than they do in other markets. The more the public buys puts, anticipating a market decline, the more likely the market is to rise; the more the public buys calls, expecting to profit from a market rise, the more likely it is that the market will fall. Subject to the caveat that pigs never make money, "contrarians" who assume the public is wrong are year-in, year-out the most likely winners in the market.

If Wall Street and the government really wish to restore investors' faith in the market, the first step should be a prohibition of the "no-compete" contract.

But the system was organized years ago with one important structural corrective for the disadvantages any visitor suffers playing on the other team's home grounds. The liaison between the financial market institutions and the public was an insider called "the customer's man." Over time, his living (it was almost always a "he" in those days) was his relationship with the people he persuaded to buy and sell securities. Their willingness to trust his judgment was his bread and butter, and it was buttered on the customer's side.

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THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W., Suite 740
Washington, D.C. 20006
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To a significant degree, the customer's man worked not for his employer but for the customer. If he felt that the firm was pushing bad stuff to his clients or loading them with unnecessary costs, he could go across the street to another firm and take his clients with him. Today that protection for the customer is gone: the individual broker he deals with has signed a "non-compete" contract promising that if he leaves the firm that now employs him he will not ask his customers to go with him.

In Fred Schwed's day, brokerage firms were partnerships–indeed, corporations could not be members of the New York Stock Exchange—and Wall Street life was a tangle of long-term relationships. Companies that issued stocks and bonds did business year after year with the same "lead banks," which in turn allocated the marketing of their underwritings to members of their own "group." In 1940, the Public Utility Holding Company Act had compelled companies in that category to award these jobs through competitive bidding, and Wall Street smarted for years at the injustice of it all. The relationship between customer's man and customer was especially personal, and firms were built on the social connections of their senior partners.

Partnership structures would not support the kind of investment financial firms needed as computers took over in the 1970s, and the NYSE changed its rules to permit corporate membership. The first to move was Donaldson Lufkin Jenrette (the same Donaldson who just became chairman of the Securities and Exchange Commission), a young firm that specialized in selling to institutions. The second, and the powerhouse behind the change, was Merrill Lynch, by far the largest brokerage firm in the world. Its leader, Donald Regan, later to be President Ronald Reagan's Treasury Secretary and chief of staff, then had to face the question of what exactly he was selling to the people who bought shares in his company. His was a business, after all, where the inventory went down the elevator every afternoon, and did not necessarily come back the next day.

Merrill had always used the term "registered representative" rather than "customer's man," and had pretended that a broker's salary did not depend on the volume of business his customers did. Now Regan had to structure a company and a product line that would bind the customer to the firm rather than to any individual in the firm. Among the products that came out of this venture were the "cash management account" that permitted customers to write checks on the values in their brokerage account, and various retirement plans that were difficult to move to other providers. And the "non-compete" clause let Merrill's stockholders assume that the business they partially owned would keep continuing access to the customers the firm generated with its advertising and promotions. This also meant Merrill could enter the underwriting business big time, promising corporations the world's longest list of potential purchasers when they wished to sell stocks and bonds.

Conflicts of interest are inescapable in every broker/dealer firm that sells its own inventory to clients while representing itself as their agent. When the Securities and Exchange Act was passed in 1935, Congress told the new SEC to study the feasibility of permanently separating the broker and dealer functions. Contrary to Wall Street myth, the study said that it could indeed be done, but the securities industry of 1935 might not survive the transition. That's not far off where today's regulators came down last year when they pondered the proposition that the brokerage end of a firm should not be allowed to sell to its customers the securities the banking end of the firm was underwriting. For the evidence was complete and convincing that in the late lamented "new economy," the big Wall Street houses used their analysts to tout the firm's customers onto stuff that the house was underwriting though they knew it was junk.

Since the big broker/dealers settled with the regulators for a fine of $1.4 billion, they have been trying to tell the world with winks and nods that really they didn't do anything wrong. Congressmen Michael Oxley (R-Ohio) and Richard Baker (R-Louisiana) have helped along their crusade for legislation to keep the state regulators and attorneys general from ever again blowing whistles at fraud on federal turf. They proudly proclaim on television that their mission in life is still to realize their customers' dreams and guarantee their customers' luxurious retirement. It got so bad that SEC Chairman William Donaldson had to remind them in public that under the "consent decree" they signed they need not admit but must not deny the charges against them.

The old days had their own problems. Faithless customer's men were not unknown, and accounts could be "churned"—innocent customers with wicked brokers could be persuaded to sell *X* and buy *T*, generating two commissions for the customer's man to split with the firm. Some people do behave better in a world where reputation matters, but webs of relationship exclude too many possible participants, and can excuse what should be inexcusable. Still, the old structure was right, and now the structure is wrong. The broker should be the investor's agent.

If Wall Street and the government really wish to restore investors' faith in the market, the first step should be a prohibition of the "no-compete" contract. Financial markets should not be places where the solitary buyer must beware. Employment contracts that recognize the individual broker's obligation to the customers as well as to the firm would be a good place to start. ◆