Conflicts of Interest in Fee-Based Brokerage Accounts

Introduction

Investors who sign up for fee-based accounts pay a percentage of the value of the assets held in the account rather than a commission or markup on each transaction.

Fee-based accounts reduce a broker’s incentive to excessively trade (“churn”) an account to generate commission income because trading does not generate explicit commissions or markups.

Brokers mostly earn higher revenues in fee-based accounts by increasing the amount of assets under management. Investors want to see their investments grow in value. Fee-based accounts do not perfectly align incentives between the broker and the customer. Serious conflicts of interest remain present in fee-based accounts.

Fee-Based Accounts Do Not Completely Align Incentives

A broker’s interest in maximizing total revenue from all clients may diverge from the interests of any individual fee-based account client.

✓ Investors who trade infrequently should hold their assets in accounts which charge commissions for transactions. Since low-trading-activity accounts do not generate many commissions, a broker benefits from converting an infrequently traded commission-based account into a fee-based account even though this may cost the investor more.

✓ A fixed-percentage fee structure creates the incentive for a broker to spend more time trying to improve the performance of larger accounts than smaller accounts. A broker can earn ten times as much in fees by improving the investment performance of a $1 million account as she can by improving the investment performance of a $100,000 account by the same relative amount.

✓ Instead of trying to improve investment performance of existing accounts, a broker can also spend her time prospecting new accounts. Both activities increase the total amount of assets under the broker’s management, and therefore her fees, but the prospecting of new accounts does not directly benefit existing account holders.

✓ Fee-based accounts can create a disincentive to trade, even when it is the most suitable course of action for the client. For example, it may be suitable for a client to sell securities to pay down high-cost debt even though this lowers the fees a broker receives in a fee-based account.

✓ Fee-based accounts can create incentives to make unsuitable recommendations. For example, a broker earns more in a fee-based account if an investor borrows against a concentrated position and buys additional securities even though it is virtually always suitable for an investor to diversify by selling some of the concentrated position.

A Mix of Fee- and Commission-Based Accounts Can Mis-Align Incentives

Portfolio managers can favor an account by paying soft dollar commissions out of a disfavored account to support trading activities in a favored account. Portfolio managers can also sometimes allocate more profitable trades to favored accounts and less profitable trades to disfavored accounts.

Brokers who handle both fee-based and commission-based accounts face similar incentives. They can use trading in the commission-based accounts to increase profits and therefore assets in fee-based accounts.

Conclusion

By altering incentives, fee-based accounts eliminate some ways in which investors can be harmed by unscrupulous brokers in commission-based accounts. Unfortunately, fee-based accounts don’t eliminate all the conflicts of interest inherent in commission-based accounts and create some additional conflicts.

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