SECURITIES LITIGATION & CONSULTING GROUP

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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