

September 22, 2004

I would like to thank the Commission for providing this additional opportunity for public comment on its proposed rulemaking, File No. S7-25-99.

Shawbrook is a sole-proprietor investment advisor based in Alexandria, Virginia. Its comments will be limited to the "fee-based" side of the proposal.

The Commission's proposal seems to be based on a number of conclusions or assumptions, which the following comments will examine.

I hope it is a legitimate part of the comment process to also note that the rulemaking proposal provides little description of the "fee-based programs" at the center of this issue. The only specific examples mentioned are contained in a footnoted reference to a handful of five-year old media articles. Certainly the subsequent five years has yielded some insight into both questions raised by the Commission and other questions. Are the fee-based accounts primarily invested in products that generate additional fees to the broker dealers? What is the quality of disclosure before the investor signs on? By failing to discuss these programs in more detail the Commission risks allowing a wide range of programs with possibly differing impacts to slide through the gap that would be opened by this proposal.

1) The Commission stated in the initial rulemaking proposal that such "fee-based" products are "responsive to the best practices suggested in the Report of the Committee on Compensation Practices ('Tully Report')." As for the "Tully Report," this country certainly didn't need a committee report to tell it that rewarding brokers largely based on the number of trades they generate might lead, especially under SRO oversight, to excessive trading in client accounts. That has almost certainly been the subject of litigation or arbitration for decades, which did not stop broker-dealers from continuing with that business model [note that apparently many continue to employ it alongside fee-based accounts, despite the fact that it is not a "best practice"]. The question is what caused broker-dealers to change their minds and seek regulatory cover to further de-emphasize commission-based compensation plans? The answer is probably not that broker-dealers had a collective ethical epiphany but rather that competitive changes in the financial services industry made it in their interests to change.

2) In the initial rulemaking proposal the Commission states, "The new programs essentially re-price traditional full service brokerage programs but do not

fundamentally change their nature.” Shawbrook does not find this statement to be credible. The competitive forces referred to above were recognized at the time as being powerful and transforming. The broker-dealer responses to them were more than a matter of “re-pricing.”

The industry situation in the late 1990’s has been well documented and is worth reviewing briefly. A brokers’ trade magazine, *On Wall Street*, described the competitive backdrop in a July 1, 2002, retrospective article: “The big news in the summer of 1999 was Merrill cutting the maximum price of its fee-based brokerage accounts to 1 percent, from 1.5 percent. Outside the industry the bigger news was the simultaneous announcement that Merrill would enter the online discount business (ML Direct was launched in December 1999). Articles appeared predicting a tough time for Merrill brokers.”

In the 1990’s brokered transactions, at least for equities, had been turned by Ameritrade and others into a low-cost commodity-type business. At the same time a lot of high-net-worth clients were seeking more objective advice from financial planners and other RIA’s. In 1998 the market capitalization of Charles Schwab’s stock passed that of Merrill Lynch.

Look at the titles of the articles that the Commission itself footnoted as evidence of these new plans: “A New Order for Brokers,” “Merrill Adapting to New Breed of Investors,” “...Schwab Takes its Biggest Risk,” and “Online Trading Forces Brokerages to Change.” The idea that these changes were no big deal is not consistent with either the size of the industry transformation taking place or the comments of industry participants and observers.

In one of the articles suggested by the commission quotes a “PaineWebber spokesperson” as saying, “A trade is just a clerical function to us. This is developing a pricing structure that pays our advisers for what they really do, which is give advice.” The New York Times wrote later in that same year, “Analysts see those moves as an acknowledgment that the execution of stock trades, once a core offering on Wall Street, is fast becoming a commodity. In essence, brokerage firms are saying, ‘Let us manage your money for a fee, and we’ll throw in the stock and bond trades.’ ” Shawbrook does not think this sounds very “incidental.”

3) The Commission also stated in its initial proposed rulemaking “These fee-based programs benefit customers by better aligning their interests with those of their broker-dealers.” [Note: In its action reopening the comment period the Commission has changed this, without comment, from a statement to the

following question: “Do current fee-based programs more closely align the interests of investors with those of brokerage firms and their registered representatives than do traditional commission-based services?”]

What is for certain is that fee-based products better “align” brokers to the strategy of their employers, a strategy which, as was discussed above, has been changing under competitive pressure.

Putting more emphasis on fee-based products helped the broker-dealers in other ways as well. Fee-based revenue helps smooth out revenue cycles related to volume changes during bull and bear market cycles. Fee-based compensation of brokers probably makes it easier for firms to implement a team approach and reduce client loyalty to star brokers, who sometimes change firms and take their clients with them. Note that none of the above benefits to broker-dealer firms from pushing “fee-based” products is necessarily in the “interests of investors.”

Whether any product is in the interest of the investor is largely dependent on the attitude of the purveyor and terms under which the product is offered. In this case the purveyors are large, extremely profitable, integrated financial firms that typically try to find multiple ways to separate the investor from their money. Brokers are the sales arm of these firms and commissioned trades are only one of many products.

Just because it now suits the broker-dealers to de-emphasize trading commissions and substitute an asset-based fee doesn't make it consumer friendly. In fact a cynic might define a broker's asset-based fee as a way to get clients to pay the broker to subject them to sales pitches for the broker-dealer's other products.

Broker dealers often take investment vehicles that in other hands are investor friendly and turn them into investor-unfriendly products. For instance an S&P 500 index fund is theoretically an investor-friendly product with a low expense ratio. However according to Morningstar, index funds with loads paid to brokers are far more likely to also have higher expense ratios. Morningstar says that the Morgan Stanley S&P 500 Index fund, class B shares, for instance has a 1.5% expense ratio, and when the customer sells the fund he or she is hit with a 5% deferred load. And even those numbers may not fully reveal the benefit to Morgan Stanley.

In short there is nothing magic about the term “fee-based.” Like the terms “index fund,” “mutual fund” and “financial advisor” these products can be anything from a tool to help enrich the investor to a way to fleece the investor.

Lacking precise detail on the way the broker-dealers reward their “reps” and manage their “fee-based” products, Shawbrook is naturally cautious about describing those products as investor friendly. Let us say that hypothetically speaking a broker who used to earn \$250,000 in commissions, sales contest prizes and bonuses now earns just \$125,000 from those sources and is additionally paid \$125,000 by the brokerage firm as their share of the asset-based fee charged to the broker’s clients. Are we supposed to believe that a broker under the new compensation system will forego the commission money and start recommending superior no-load funds instead of inferior load funds on which he or she would earn a commission? Are we supposed to believe that the brokerage firm would be any happier if they did, especially if those recommendations did not favor in-house load funds, wrap accounts or “managed account” products from which the broker-dealer itself earned revenue?

4) The Commission asks: “Should we require broker-dealers who would seek to rely on the rule nevertheless to register if they market fee-based accounts based on the quality of investment advice provided?”

If I were a broker-dealer reading the preceding question I would be very happy because I could immediately see a hundred ways to get around the rule’s intent.

Take for instance the AG Edwards television ad that I saw last week. Without ever mentioning the word broker or broker-dealer it described its sales person as “A financial consultant motivated only by your needs.” Arguably there was no real mention of the quality of investment advice; thus arguably there would be no need to register. Broker-dealers, armed with billions of dollars from pushing various products on investors can create and run scores of “warm and fuzzy” TV ads that never mention the words broker or broker-dealer and never mention the substantial conflicts of interest inherent in the “advice” of a broker-dealer.

Shawbrook urges the Commission to rein in such ads as have been run over the past several years. Other government entities which seek to protect consumers, such as the FDA and the FTC, regularly stop purveyors of goods and services from misrepresenting who they are and what they offer to individuals.

There is no question that broker-dealers are trying to masquerade as financial advisors; it is openly discussed in their professional forums and publications. Another trade magazine for brokers, *Registered Representative*, said in a September 13th article: "If you are like most registered reps, your card probably says you are a financial advisor – and not a stockbroker. Indeed, whether you work at a large Wall Street brokerage or a small broker/ dealer, the odds are you are holding yourself out as a well-rounded financial advisor and not just, say, a stock jockey."

While it may be true that a change in retail client pricing plans and broker compensation, for whatever motivation, may have a partial beneficial effect on certain brokers at certain firms, it is also probably true that allowing brokers to continue to market themselves as "financial consultants" [or whatever other term suggests the attributes of a registered investment advisor] is having a far greater detrimental effect by misleading the public.

The bottom line is that under current Commission policy the broker-dealers are "holding themselves out" as advisors and fiduciaries without the accompanying regulation and without prominently disclosing any conflicts of interest when in fact their companies are designed and operated specifically to profit from conflicts of interest. Even if this were not a violation of securities laws, it is competitively unfair to others in the broad financial services industry and is hostile to investors. With this proposed rulemaking the Commission seems to be favoring one segment of the industry, and ironically the one in which recent regulatory missteps by either certain broker-dealer arms or their parent companies [such as the "sixteenth's" market making scandal and the analysts' research scandals, etc.] vastly overshadow missteps by the financial planners and others who are disadvantaged by this proposed rule. Shawbrook urges that the Commission immediately reject the proposed rulemaking as it applies to "fee-based brokerage programs."

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