

PACE INVESTOR RIGHTS PROJECT

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November 22, 2004

Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: File Number SR-NYSE-2004-13 — Request for Comment

Dear Mr. Katz:

We are writing in response to the Commission's request for comments to the Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the New York Stock Exchange, Inc. to Adopt Rule 405A ("Non-Managed Fee-Based Account Programs — Disclosure and Monitoring"). We are commenting on behalf of the Pace Investor Rights Project whose mission includes advocacy in the area of investor justice. We generally support approval of Rule 405A because it prescribes investor protections that continue throughout the lifecycle of a customer relationship.

There is substantial debate about fee-based versus commission-based compensation systems.¹ In recent years, firms have increased their marketing of fee-based programs, asserting that fee-based programs benefit customers by more closely aligning their interests with those of their broker-dealers, an assertion the Securities and Exchange Commission (SEC) appears to agree with.² Fee-based programs may deter classic broker-dealer fraud such as churning and provide customers with some assurance that their brokers' advice is not given to generate more broker income. In addition, some customers may prefer a consistent, recurring charge for their brokers' services. On the other hand, costs for fee-based programs will be higher for customers who engage in infrequent trading activity, particularly for those who follow a buy-and-hold strategy, an investment strategy generally more appropriate for small or inexperienced investors. Moreover, fee-based programs may provide incentives for excessive trading by offering volume

¹ See, e.g., Report on Broker-Dealer Compensation (Apr. 5, 1995) (the Tully Report) at 7.

² See, e.g., Certain Broker-Dealers Deemed not to be Investment Advisers, 1999 WL 999763 (SEC Rel. No. 34-42099) at *3.

discounts. Because there are advantages and disadvantages to both fee-based and commission-based compensation systems, we agree that customers should be able to make an informed choice about which better meets their objectives.

The proposed rule imposes mandatory pre-account opening disclosures designed to enable a customer to make a reasonably informed determination of the program's appropriateness. Similarly, the broker-dealer is also required to make a determination based on the services provided, the anticipated costs, and the customer's objectives. We agree with the proposed rule's premise that the broker-dealers' suitability obligations are triggered by offering customers fee-based programs. A broker should not place a customer in a fee-based program that is likely to result in increased costs to the customer, unless the broker can document that the customer made an informed choice to pay more for the services, based on his assessment of the value of those services.

Additionally, at a minimum of twelve-month intervals, the broker-dealer is required to reassess the appropriateness of the account program selection to ensure that it continues to make sense for the customer. We agree that a mandatory and periodic self-checking mechanism will benefit customers. Broker-dealers should have a continuing obligation to make sure, based on their customers' trading history, that a fee-based program continues to be a suitable choice for them.

Cost and Non-Cost Factors

We agree with the proposal's statement that "[c]ost is an important factor, but not the only one" in determining whether a fee-based account program is appropriate. Nevertheless, we do believe that where a switch from a commissioned-based account to a fee-based account is likely to result in a large increase in the customer's costs, there is a strong presumption that the fee-based account is an inappropriate choice. According to press reports, regulatory scrutiny of fee-based programs has focused primarily on costs, and the New York Stock Exchange's enforcement division is investigating overpayments ranging from \$2,000 to \$50,000 per customer.³ It is our understanding that the SEC and NASD are conducting similar investigations.

Although we can envision a scenario where non-cost factors might justify a smaller incremental increase in overall cost, e.g., where a customer conducts few transactions but may demand a significant amount of "handholding" on the part of the broker, we are hard pressed to believe that any scenario might justify a \$50,000 differential. However, we might be receptive to differentials in the \$1,000 to \$1,500 range because the annual minimum fees for the more popular programs fall within that range.⁴ We also find it plausible that a long-time customer might commit to these minimums in lieu of starting over at another brokerage firm or facing reassignment to a call center.⁵ In any event, the decision-making process should be a well-informed and well-documented one.

³ See Ruth Simon, *Fee Accounts Face Scrutiny By Regulators*, Wall Street Journal, October 5, 2004, at D1, available at 2004 WL-WSJ 56942744.

⁴ Merrill Lynch's Unlimited Advantage: \$1,500; Morgan Stanley's Choice: \$1,000.

⁵ Inactivity fees might also be assessed to customers who generate little account activity.

Alignment of Interests

Much has been said about the potential of asset-based fees to align the interests of customer and broker. NASD, however, has recognized that fee-based programs do not always align the customer's and the broker's interests.⁶

Moreover, the NYSE proposal states that a non-cost factor to be considered when evaluating whether a fee-based account is appropriate is “the importance that a *customer places* on aligning his or her interests with those of the broker” (emphasis added). Interestingly, when Merrill Lynch was about to launch its Unlimited Advantage program in 1999, its print display advertisement said the following: “This new [fee-based] plan ensures that we all march to the same incentive: growing your assets. When you succeed, we succeed.”⁷ That original context seems to suggest that the interests of the customer come first. The NYSE’s version suggests that the interests of the broker come first. The net result may be that a customer should be prepared to pay more for less. However, as we noted earlier, this may be acceptable within limits. Nonetheless, this result should not be confused with a genuinely cooperative concept of “alignment of interests.”

Disclosure Materials

We recommend disclosure documentation that allows a customer to compare the cost of a fee-based program with a commission-based program for a given level of transaction volume and asset mix. We believe that this information should be provided graphically using ranges of transaction volumes and asset mixes. For example, asset mixes could be represented along a horizontal scale (from left to right: 100% fixed income/mutual funds to 100% equities) and transaction volumes could be represented on a vertical scale. A cost threshold line would divide the grid into two areas. A customer falling in the area above the line would likely find a fee-based account less expensive. A customer falling in the area below the line would likely find a commission-based account less expensive.

If a customer’s only concern is cost, then the analysis could end here. However, if the customer is willing to pay for some intangibles such as handholding or to align his interests with those of the broker, then the cost threshold line could be shifted downward thus justifying a fee-based account at lower transaction volumes. As we noted previously, we would not favor a downward shift that was equivalent to more than the minimum annual fee.

Monitoring Obligations

We believe that ongoing suitability assessments will provide benefits to clients without imposing significant burdens on broker-dealers. In fact, we believe that many broker-dealers currently perform the relevant activity-based analyses for internal purposes. We recommend that

⁶ NASD gives as an example a broker's not recommending income-producing securities, even when suitable for the customer, because these investments would result in lower fees than would be generated by capital appreciation stocks. See NASD Notice to Members 03-68, Fee-Based Compensation (Nov. 2003) at n. 4.

⁷ Merrill Lynch & Co., Advertisement, The New York Times, June 2, 1999, at C14, *available at* ProQuest Historical Newspapers.

any client contact related to proposed Rule 405A's monitoring obligations be memorialized on the client's account statement for easy client access. We also recommend that one statement cycle prior to a fee-based program's re-enrollment date, the account statement include a reminder suggesting that the client review his or her trailing and anticipated activity levels with the broker.

For the reasons stated above, we support the proposed rule.

Respectfully submitted,

/s/ Barbara Black

Barbara Black, Co-Director

/s/ Jill I. Gross

Jill I. Gross, Co-Director

/s/ Bob Kim

Bob Kim, Student Intern