COMMISSIONS ON SALES AT BROCK MASON BROKERAGE by Tom L Beauchamp

James Tithe is manager of a large branch office of a major Midwestern brokerage firm, Brock Mason Farre Titmouse. He now manages 40 brokers in his office. Mr. Tithe used to work for E. F Hutton as a broker and assistant manager, but when that firm merged with Shearson-Lehman/American Express, he disliked his new manager and left for Brock Mason. He knew the new firm to be aggressive and interested primarily in limited partnerships and fully margined common stock. He liked the new challenge. At Hutton his clients had been predominantly interested in unit investment trusts and municipal bonds, which he found boring and routine forms of investment. He also knew that commissions are higher on the array of products he was hired to sell at Brock Mason.

Although bored at Hutton, James had been comfortable with the complete discretion the firm gave him to recommend a range of investments to his clients. He had been free to consult at length with his clients, and then free to sell what seemed most appropriate in light of their objectives. Hutton of course skillfully taught its brokers to be salespersons, to avoid lengthy phone calls, and to flatter clients who prided themselves on making their own decisions; but the firm also did not discourage the broker from recommending a wide variety of products including U.S. government bills, notes, and bonds, which averaged only a $75 commission on a $10,000 bond.

This same array of conventional investment possibilities with small commissions is still available to him and to his brokers at Brock Mason, but the firm has an explicit strategy of trying to sell limited partnerships first and fully margined common stock second. The reason for this strategy at the brokerage house is that commissions on a $10,000 investment in a limited partnership run from $600 to $1,000, and commissions on a $10,000 investment in fully margined common stock average $450.

James has been bothered for some time by two facts: The first fact is that the largest commissions in the brokerage industry are paid on the riskier and more complicated forms of investment. In theory, the reason is that these investments are more difficult to sell to clients. Real estate and oil and gas drilling partnerships, for example, typically return between 4 percent and 8 percent to sellers—although lately most have been arranged to return the full 8 percent. Some partnerships return more than 8 percent, because they rebate management fees to any securities firm that acts as a participant in the partnership.

The second fact is that James trains brokers to make recommendations to clients based on the level of commission returned to the broker and the firm. He is therefore training his brokers to sell the riskier and more complicated forms of investment. Although Brock Mason, like all brokerage firms, advertises a full range of products and free financial planning by experts, all salespersons dislike financial planning per se because it takes a large amount of time and carries zero commission.

James has long appreciated that there is an inherent conflict of interest in the brokerage world: The broker is presumed to have a fiduciary responsibility to make recommendations based on the financial best interest of the client; but the broker is also a salesperson who makes a living by selling securities and who is obligated to attempt to maximize profits for the brokerage house. The more trades made, the better it is for the broker; although this rule seldom works to the advantage of the client. Commissions are thus an ever-present temptation in the way of presenting alternatives or making an entirely objective recommendation.

Brock Mason does have a house mutual fund that is a less risky form of investment—the Brock Mason Equity-Income Fund. But the return to brokers and to the firm is again substantial. The National Association of Securities Dealers (NASD) allows a firm to charge up to an 8.5 percent commission or load on a mutual fund, and Brock Mason charges the full 8.5 percent. As an extra incentive, an additional percentage of the commission on an initial investment is returned to a broker if he or she can convince the client to automatically reinvest the dividends rather than have them sent by mail. Brock Mason also offers a fully paid vacation in Hawaii for the five brokers who annually sell the largest number of shares.

The firm has devised the following piggyback strategy: Brokers, as we have seen, are trained to sell limited partnerships first and fully margined stock accounts second. In the latter accounts an investor is allowed to purchase stock valued at up to twice the amount of money actually deposited in the account. The "extra" money is a loan from the brokerage firm. Twice the normal stock entails twice the normal commission on the amount of money in the account. In addition, salespersons are given a small percentage of the interest earned on the loan made to the client.

Brock Mason, like most brokerage firms, is now suffering because a stock market slump has caused business to fall off sharply. Business has been off 24 percent, and Brock Mason is encountering difficulty paying for the sophisticated electronic equipment that sits on each broker's desk. James's superiors are pressuring him to persuade his brokers to aggressively market limited partnerships as a solid form of investment during a period of instability in stocks.

Last year the average annual commission brought into a film by a broker in the U.S. brokerage industry was $249,500. Each broker personally takes home between 25 percent and 50 percent of this amount, depending on the person's contract and seniority: James's take-home earnings last year amounted to $198,000, 35 percent more than he had ever earned at Hutton. A friend of his began his own financial planning firm last year and retains 100 percent of his commissions, netting him $275,000 in his first year. His friend rejected the idea that he charge a flat fee or a percentage of profits in lieu of commissions for his recommendations and services. In his judgment, flat fees would have cost him more than 30 percent of his earnings.

Securities firms are required by law to disclose all commissions to clients. However, James and his brokers are aware that limited partnerships and mutual funds are usually easier to sell than straight stock and bond purchases, because the statistics on fees are buried beneath an enormous pile of information in a prospectus that most clients do not read prior to a purchase. Most clients do not obtain the prospectus until after the purchase, and there is no report of a dollar figure for the commission. Brokers are not required to disclose commissions orally to clients and rarely do; moreover; it is well known that clients virtually never ask what the commission is. James has been instructed to tell his brokers to avoid all mention of commissions unless the subject is explicitly raised by the client.

The Securities and Exchange Commissions (SEC) does not set ceilings on commis-sions and does not require a broker to receive a written consent from a client prior to purchase. The SEC does occasionally determine that a markup is so high at a brokerage house that the commission amounts to fraud. It is here that James has drawn his personal "moral line," as he calls it. He has tentatively decided that he will market any product that has passed SEC and NASD requirements. Only if the SEC is considering a judgment that a markup is fraudulent will he discourage his brokers from marketing it.

But James also wonders about the prudence and completeness of these personal guidelines. He has been around long enough to see some very unfortunate circum-stances-they are *unfortunate* but not *unfair,* in his judgment—in which unwary clients bought unsuitable products from brokers and had to live with the consequences. Recently one of his brokers had steered a 55-year-old unemployed widow with a total account of $380,000 (inherited upon the death of her husband) into the following diversification: 25 percent in limited partnerships, 25 percent in dividend-paying but margined stocks, 25 percent in corporate bonds yielding 9.8 percent, and 25 percent in the mutual fund. But the woman had not appreciated at the time of purchase how low the dividends on the stocks and the mutual fund would be. She now has far less annual income than she needs. Because she cannot sell the limited partnerships, she must now sell the stock at a loss and purchase a high dividend-paying instrument.

James and the woman's broker have been modestly shaken by this client's vigorous protest and display of anger. James decided as a result to take the case to the weekly staff meeting held on Wednesday mornings, which all brokers attend. There was a lively discussion of the best form of diversification and return for the widow. But James's attempt to introduce and discuss the problem of conflict of interest during this session fell completely flat. His brokers were not interested and could not see the problem. They argued that the brokerage industry is a free-market arrangement between a broker and a client, who always knows that fees are charged. Disclosure rules, they maintained, are well established, even if particular percentages or fees are sometimes hidden in the fine print. They viewed themselves as honest salespersons making a living through a forthright and fair system.

James walked away from this meeting thinking that neither the widow nor the broker had been prudent in making decisions that met her specific needs, but again he viewed the outcome as unfortunate rather than unfair. He had to agree with his brokers. No client, after all, is forced either to deal with the firm or to make any purchase.