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Ruling puts pressure on popular investment option

By Peter Hull
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Photo by Tyrone Walker

Doug English of Scientific Investors in North Charleston says people who are considering a switch to commission- based advisory accounts from fee- based accounts need to ask themselves: “Am I benefiting from this advice?”

By his own admission, Tom Skorepa is no Wall Street whiz kid. But the semiretired engineer from Summerville is not a total novice either when it comes to investing his savings.

So he was surprised to learn recently that money he invested years ago for retirement and his grandchildren's college funds was not required to be managed with his best interests in mind. And it was all perfectly legal.

The types of investments, called fee-based brokerage accounts, are commonly offered by the country's largest and most powerful securities firms. Collectively, some $300 billion in assets is held in these accounts, largely in retirement plans, by household names such as Merrill Lynch, Morgan Stanley and UBS.

That's all about to change.

Recently, a federal court ruled these brokerages and others no longer can offer fee-based accounts. The reason: They allowed brokers to charge clients such as Skorepa for financial advice without being registered as investment advisers. That means the companies had no fiduciary responsibility to act in their client's best interests.

To Skorepa, 62, that just doesn't add up.

"If I wanted to lose money, I'd go to Las Vegas — and I'd have some fun doing it," he said.

Skorepa has since switched from fee-based accounts to an investment adviser. A recent decision by the Securities and Exchange Commission that triggered the end to fee-based brokerage accounts likely will force about a million other investors to make similar moves with their money over the coming months.

Some investment houses with sizable operations in Charleston are already responding to the new regulatory environment. Wachovia Corp., for example, has asked its brokers to stop opening new fee-based accounts, also known as wrap accounts, according to reports.

The shift stems from a 1999 SEC rule that made brokers exempt from parts of the Investment Advisers Act of 1940. The rule allowed brokers to give clients "incidental" investment advice without being registered advisers. The fee-based brokerage accounts gained popularity because clients paid a flat annual fee regardless of the number of trades they made.

The accounts particularly suited active traders who otherwise had paid a commission for each transaction.

But in March, the U.S. Court of Appeals for the District of Columbia, in response to a legal challenge by the Financial Planning Association, overturned the SEC rule.

The association had objected to brokers being allowed to give financial advice without having to jump through the same regulatory hoops as registered advisers.

Brokerage firms are required to disclose that fee-based accounts aren't advisory accounts, but the distinction is lost on many clients, said Doug English, a certified financial planner with Scientific Investors in North Charleston.

"I would be shocked if the public knew that," English said. "Either way, you don't get a fiduciary obligation."

Investors with fee-based accounts may consider switching to commission-based advisory accounts, English said. That decision would depend on individual circumstances, such as the number of trades investors make.

"One of the questions you should ask yourself is, 'Am I benefiting from this advice?' " English said.

The bottom line is accountability, said Chip Hardy, a registered investment adviser with PrimeTrust Advisors in Columbia.

Prior to the court's ruling, brokers could sell products that were "suitable" for their clients, whereas advisers have a fiduciary obligation, meaning they are required by law to put the investor's best interests first. Most average investors probably don't know the difference, Hardy said, leaving many with a false sense of security.

"What's suitable for you may be better for the broker," he said.

Late last month, the SEC said it would not appeal the court ruling that effectively put an end to fee-based investment vehicles. The agency also asked for a stay on the decision until Oct. 1 to give brokers time to figure out what they plan to do with the accounts.

Morgan Stanley has said its clients need do nothing immediately. James Wiggins, executive director of corporate communications for Morgan Stanley Global Wealth Management Group, said affected investors will be contacted by their financial advisers to consider alternative account options.

The company has a range of alternative accounts, both brokerage and advisory, that clients will be able to choose. A number of those options will have comparable pricing, Wiggins said.

But executives at Merrill Lynch, the brokerage that holds about one-third of the nation's fee-based accounts, by far the largest share, "strongly disagree with any action" that would end brokers offering the option.

In a memo written after the SEC decision, Robert J. McCann, president of Merrill Lynch's Global Private Client Group, said the accounts are popular with clients because they offer a flat rate and the opportunity for more active traders to save money.

"We believe these accounts offer the best chance for many of our clients to obtain a full range of services at attractive prices," McCann wrote. Merrill Lynch "will work with regulators to preserve our clients' choice" to keep the accounts, the memo states.

As for Skorepa, who had less than $100,000 invested in fee-based accounts, thinks the change will benefit him. He estimated those accounts cost him about $500 a year, for which he says he felt he got little in return. Looking back, the money would have been better off sitting in a bank account or money market, he said.

"Someone was making money on it, but it wasn't us," he said.

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