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WASHINGTON STATE DEPARTMENT OF FINANCIAL INSITUTIONS SECURITIES DIVISION NON-MANAGED FEE-BASED ACCOUNTS EXAMINATION RESULTS SUMMARY REPORT

The Securities Division of Washington State's Department of Financial Institutions conducted a series of examinations of broker-dealers that offer their customers Non-Managed Fee-Based Accounts. The examinations primarily took place at branches of major national broker-dealers. This report describes the findings from those examinations and focuses on the implications of those findings for Washington customers who hold or who are considering opening such accounts.

Summary

The Securities Division found that, over several years, Washington customers holding non-managed fee-based accounts ("NMFBA") paid fees totaling more than $2.3 million for accounts in which there were no trades. These customers received no apparent benefit from participation in the NMFBA accounts. The fees they paid did not entitle them to ongoing investment advice or professional supervision of their accounts. These customers would not have been subject to these fees if they had remained in standard transaction-based commission accounts. In a standard brokerage account, the customer pays a commission based on the trades the customer makes in the account. Usually, the commission is charged per trade or on the dollar amount of the trade.

The Securities Division conducted the examinations because of concerns regarding the marketing and supervision of NMFBA programs. These concerns were reinforced by recent regulatory actions by the New York Stock Exchange ("NYSE") and the National Association of Securities Dealers ("NASD"),[1] as well as a rule passed by the United States Securities and Exchange Commission ("SEC") which sought to authorize, through rulemaking, the use of such accounts at brokers or dealers.

[1] The NYSE and the NASD have merged and are now called the Financial Industry Regulatory Authority or FINRA.

In its examinations, the Securities Division found that some of the broker-dealers offering NMFBA programs were deficient in the monitoring of the accounts to ensure that the NMFBA accounts were suitable for the customers based on the level of trading in the customers' accounts.

The examinations focused on whether the best interests of the customers were being served in NMFBAs and whether customers were receiving the services that they paid for in these programs. For the purpose of this report, the Securities Division has limited its analysis to the most troublesome activities: accounts where few or no trades were made during the period.

What Are NMFBAs?

A NMFBA is a brokerage account held by a retail customer. The broker-dealer charges the customer fees based on the value of the assets in the account as determined on a periodic basis. Whereas in a standard retail account, the customer pays a commissions on agency trades or markups or markdowns on principal trades when transactions are executed. A customer with a NMFBA does not give the broker discretion to make trades without the customer's approval. For ease of reading, we will refer to transaction charges paid by brokerage customers as commissions whether those charges are associated with agency or principal transactions.

NMFBA History

In standard brokerage accounts, customers pay a commission based on each trade in the account. The more trading in the account, the higher the compensation received by the firm and securities salesperson. This creates an incentive for security salespersons to recommend trades to customers and encourage trading.

In 1995, a panel commissioned by the SEC issued the Tully Report. The report addressed concerns and conflicts of interest within the brokerage industry relating to compensation practices. Because securities salespersons receive compensation based on the number of trades executed, there is an inherent incentive to churn, or excessively trade, accounts. The report stated, in part, that the existing commission-based compensation system works well for the vast majority of customers, but the interests of all principal parties involved would be better served

by allowing customers the option to pay for trading services through fees based on the value of securities in the account.

As a result of the Tully Report, the industry expanded the use of fee-based accounts. The increased use of such accounts led securities self-regulatory organizations to issue guidance to their members on their use. In November 2003, the NASD issued Notice to Members 03-68 ("Notice"). This Notice cautioned member firms that NMFBA programs may not be appropriate for all customers and that firms must have "reasonable grounds for believing that a fee-based program is appropriate for a particular customer, taking into account the services provided, cost, and customer preferences."

In June 2005, the New York Stock Exchange ("NYSE") adopted Rule 405A. The rule not only defined the term NMFBA, but also prescribed requirements relating to providing account disclosures, assessing customer appropriateness, monitoring transactional activity, and establishing a follow-up system to contact customers. Specifically, the rule required firms to disclose the service provided, the eligible assets, the fees charged, cost computations, conditions or restrictions, and a summary of the advantages and disadvantages. Further, it required firms to regularly review the NMFBA to guard against conflicts of interest and to have specific written criteria to identify customers who may be inappropriate for the program.

The SEC then permitted brokers and dealers to begin to charge asset-based fees in lieu of trade-based commissions. In 2005, the SEC adopted 17 CFR Part 275, which formally exempted brokers and dealers from the investment adviser registration requirements when brokers or dealers offered accounts subject to an asset-based fee, subject to certain conditions. To qualify for the exemption, any investment advice given by the broker or dealer had to be solely incidental to the brokerage services provided. Discretionary accounts did not qualify for this exemption.

In March 2007, the United States Court of Appeals for the D.C. Circuit vacated the rule adopted by the SEC in 2005 that exempted broker-dealers from the investment adviser registration requirements. The court found that the SEC did not have the statutory authority to adopt the rule.

It found that the rule was inconsistent with federal law because it created an exemption from investment adviser registration for brokers and dealers broader than the limited statutory exemption created by Congress in the Investment Advisers Act of 1940. The limited statutory exemption is available only to brokers or dealers who perform investment advisory services that are solely incidental to conducting business as a broker or dealer and for which it receives no special compensation.

Despite the adverse court decision, fee-based accounts have not disappeared entirely. NMFBAs will be regulated under the Investment Advisers Act of 1940. A number of broker-dealers have said that they intend to continue to offer such accounts. In order to accommodate them, the SEC has provided some regulatory relief. On September 24, 2007, it adopted a temporary rule granting relief to dealers regarding principal trades with certain advisory clients. (Release IA-2653). The SEC also proposed an interpretive rule under the Investment Advisers Act affecting broker-dealers. This proposed rule reinstated some interpretations that had been part of the rule vacated by the court. (Release IA-2652)

Securities Division Examinations

In 2005 and 2006, the Securities Division conducted a focused sweep of the NMFBA programs of the seven major NYSE firms operating in Washington State as well as several smaller firms. The Securities Division performed on-site examinations at the firms' largest branch offices, conducted interviews, reviewed reports, and analyzed account records provided by the firms. The purpose of the sweep was to understand each firm's NMFBA program, including but not limited to:

- suitability of the accounts;
- volume of the trading activity and fees generated;
- fee schedules, including any minimum fixed fees;
- eligibility criteria for enrollment into the program;
- eligible assets used in billing calculations versus ineligible assets;
- treatment of mutual funds and hedge funds in the accounts;
- description of the supervision and monitoring process; and
- termination and refund policies.

While information released by the brokerage firms indicated that customers as a whole have benefited from NMFBAs, the Securities Division's examination focused on the accounts on a case-by-case basis to see what customers received versus what customers paid in actual NMFBA fees. The Securities Division found that reports of customers saving money by investing in a NMFBA were skewed by large customers who had the ability to negotiate specific, preferred NMFBA arrangements unavailable to the average customer. The savings of the large customers overshadowed the reality that smaller customers often paid more for being in a NMFBA than in a traditional commission-based brokerage account.

One of the arguments used by broker-dealers in defense of NMFBAs is that, in a NMFBA, the customer is relieved of the burden of transaction-based commissions through the ease of quarterly payments. However, the Securities Division noted that broker-dealers already offered accounts that charged fixed fees, and that the increased cost of the quarterly fee in the NMFBA may have outweighed its convenience.

The Securities Division also found, as described below, that some of the broker-dealers failed to supervise the accounts adequately and that some firms appeared to violate the investment adviser registration provisions.

Excessive Fees

As mentioned, an analysis of the nine broker-dealer firms showed that in the selected two-year period,[2] Washington State residents were charged fees of over $2.3 million in NMFBAs where no trades were made. If these customers had been placed in brokerage accounts with a standard trade-based commission structure, these customers would not have incurred any trade-related fees for the years examined. Below is a summary of the information relating to NMFBA fees collected by the brokerage firms in accounts open for more than one year, with no trades.

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[2] Each firm's records retention policies and methods for compiling data varied. This report shows data based upon twelve-month periods that might not be calendar years. Additionally, some of the firms provided information from 2004 and 2005 while others provided 2005 and 2006. Firms C and E only submitted data for one year. Firm H provided combined data for 2004 and 2005 which was not segregated by year. The combined data was placed in Yr 2. The number of NMFBAs is the number of accounts at the time of the examination.

Chart A: NMFBA Accounts Showing No Trades at Firms Examined During the Securities Division's NMBFA Project

Brokerage Firm	# NMFBA	NMFBA Revenue as a % of Total Revenue	# Accts. w/ No Trades in Yr 1	Fees from Accts. w/ No Trades in Yr 1	# Accts. w/ no trades in Yr 2	Fees from Accts. w/ No Trades in Yr 2	Total Fees from Accts with No Trades for Yr 1 & 2
Firm A	2,728	No Data	154	$ 182,901	345	$ 203,028	$ 385,929
Firm B	4,107	16.55%	284	$ 205,853	111	$ 228,471	$ 434,324
Firm C	2,838	No Data	No Data	No Data	104	$ 383,392	$ 383,392
Firm D	2,921	12.65%	576	$ 532,336	248	$ 274,234	$ 806,570
Firm E	224	0.02%	9	$ 16,899	25	$ 92,886	$ 109,786
Firm F	5	0.09%	2	$ 4,102	6	$ 22,320	$ 26,422
Firm G	78	No Data	6	$ 9,516	9	$ 7,115	$ 16,631
Firm H	1,047	26.10%	41	$ 91,464	25	$ 55,332	$ 146,795
Firm I	478	8.30%	No Data	No Data	10	$ 18,695	$ 18,695
			1072	**$ 1,043,071**	883	**$ 1,285,473**	**$ 2,328,544**

For the chart above, the Securities Division analyzed only accounts with zero trades and found that customers were charged over $2.3 million in fees which appeared to be excessive because there were no trades in the accounts.

Based on the data supplied by the firms, there also appears to be a significant number of accounts with a very limited number of trades over the selected time period. The customers with a very limited number of trades paid unreasonable fees as compared with what they would have paid had they been in a standard brokerage account. . The following chart provides specific examples

of accounts with zero trades or limited trading during a twelve month period and the amount the customer paid in fees that appeared unreasonable.[3]

Chart B: Selected Examples of Customer Accounts Showing Excess Fees Paid by Customers in NMFBAs

Specific Customer Accounts	Account Assets	NMFBA Fees	Suppressed Commission	Excess Fees	Trades During 12 Month Period
Customer 1	$1,529,563	$4,143	$0	$4,143	0
Customer 2	$4,794,210	$31,058	$0	$31,058	0
Customer 3	$820,935	$6,870	$0	$6,870	0
Customer 4	$1,505,584	$14,798	$0	$14,798	0
Customer 5	$661,203	$9,060	$0	$9,060	0
Customer 6	$4,110,549	$23,732	$750	$22,982	1
Customer 7	$2,640,891	$21,483	$935	$20,548	10
Customer 8	$493,626	$17,588	$3,747	$13,841	12

Customers 1 through 5 represent specific examples of accounts that had no trading activity in the account for the 12-month period analyzed. These five customers collectively paid over $65,000 in fees yet had no trades in their account during a 12-month period.

Customer 1, an 85-year-old widow, paid $4,143 in fees when she had no intention of making any trades in her account. In fact, her broker justified the fees charged by saying that he was entitled to the fees because he was researching the tax implications of selling her securities.

Customers 2 through 4 should have been removed from the NMFBA program because they had only limited trades in their accounts the prior year. Customer 2 had only one trade in the prior 12-month period. Customer 3 had only two trades in the prior 12-month period and Customer 4

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[3] The account assets column contains the value of the NMFBA. The NMFBA fees column contains the fees paid in the twelve month period. The suppressed commission column contains the commissions the customer would have paid in a traditional commission based fee structure. The excess fees column contains the difference between the fees paid and the suppressed commission.

had only six trades in his account during the prior 12-month period. The firms should have reviewed the trading history for the prior year and removed them from the program a year earlier. In some cases, the firm changed the software it used to track NMFBA during the period in such a way that it was unable to look back more than a year at a customer's trading history in an account. In other cases, the firm waited 15 months or more before reviewing trading history for NMFBA customers.

Customers 6 through 8 illustrate that even accounts with some limited trading activity proved costly to customers. These three customers paid $62,804 in fees in one year, yet they would have paid only $5,432 in commissions had they been in commission-based accounts, a difference of $57,372.

The firms varied on whether customers were informed of the suppressed commissions generated by their accounts. Suppressed commissions are the amount the customer would have paid if the account had been a standard commission-based account. A customer who knows about suppressed commissions can compare the NMFBA fees paid with what the customer would have paid in a per trade commission structure. The customer can then evaluate the benefit, if any, received from the NMFBA. Some firms did not provide this information to customers.

Some firms required that a customer stay in the NMFBA for one year. The Securities Division was concerned that a customer with no trades in the NMFBA who stayed in the program for an entire year paid excessive fees. Several firms responded to the concern that excessive fees were charged by comparing the NMFBA to a health club membership. The person who purchases a health club membership is committed to a year membership regardless of the amount the health club is actually used, just as in a NMFBA. The firms asserted that they needed a year to evaluate the customer's usage of the NMFBA before determining whether the NMFBA was suitable for a customer. However, what this comparison overlooks is that unlike the health club owner, the broker-dealer has information about the customer's prior trading history prior to the opening and acceptance into the NMFBA program. Further, the broker-dealer has a duty to ensure that the program is suitable for the customer, a duty to monitor the accounts, and an ongoing duty to

supervise the account. Lastly, the broker-dealer has the duty to remove a customer from a NMFBA if the customer has too few trades in the account.

Determining the Fee Based on Type of Assets in the Account; Suitability of Various Asset Types for the NMFBA

The fee charged in the NMFBA varied among the firms. The fee might be either a fixed percentage of all the assets in the account or based on a percentage of assets in the account depending upon the type and value of assets held in the account. Chart C shows the range of fees charged across the firms for the following asset types:

Chart C: Range of Fees Charged By Type of Asset

Asset Type	Fee
Equities	.75-2%
Mutual Funds	.5-1%
Fixed Income & Cash	.25-.6%

The fees for mutual funds, fixed income assets, and cash were lower because the customer is less likely to trade these assets. The supposed advantage of a NMFBA is that the annual fee is less than the commissions that would be charged in a traditional commission-per-trade account. The reasonableness of putting a customer in a NMFBA is called into question when the assets held in the account are unlikely to be traded. Some firms were more attentive than others to the character of the assets in a customer account and whether those assets were suitable for a NMFBA.

Duties and Obligations: Procedures and Safeguards Not Followed

Under NYSE Rule 405A and NASD Notice to Members 03-68, firms must establish systems and procedures to effectively monitor and supervise the NMFBA programs. The firms have an obligation to closely monitor their NMFBA programs.

The Securities Division examinations revealed that many of these firms did not have proper monitoring programs in place and that some firms did not effectively supervise the NMFBAs. Some firms adopted NMFBA programs before having the tools to adequately monitor and

supervise those programs. Some firms changed their monitoring software frequently so that it was not possible to compare a customer's use of a NMFBA account from year to year. Even where sufficient monitoring programs were in place, some of the firms did not effectively supervise the NMFBA program by taking corrective action based on information provided by the monitoring system. As a result, some customers remained in NMFBA accounts for years even though those customers had little or no trading activity and did not appear to benefit from the fees they paid to maintain such accounts.

Merely having tools in place for monitoring NMFBA account programs is not adequate firm compliance and oversight. A firm offering NMFBA must also use the information from the tools to take effective action. Our analysis concluded that some of the firms did not diligently take corrective action in accounts with light or no trading activity to ensure that fees charged to the customer were not unreasonable. In fact, some customer accounts appeared on the monitoring reports for two consecutive years and were allowed to remain in the NMFBA program. In addition, while firms were often dilatory in taking action for the benefit of the customer, most firms were diligent in monitoring and terminating accounts from the NMFBA program where the trading activity was too high for the program thus reducing the revenue to the firm. Firms were generally prompt to close a customer's NMFBA if the customer was trading more than the firm thought he or she should be in the NMFBA.

Registration Issues

Even under the 2005 SEC rule broker-dealers were able to offer the NMFBAs without being registered as investment advisers only if they provide solely incidental investment advice, asset allocation, and portfolio management services. If the investment advice, asset allocation, and portfolio management services offered in a NMFBA were more than incidental services, the broker-dealer exceed the exemption from registration. The Securities Division examination found that at least one broker-dealer's NMFBA program may have exceed the registration exemption by providing the services of an investment adviser while not being registered as such. See Chart B, Customer 1, where the broker stated that he was entitled to the fees in an account with no trades because he was researching the tax implications of selling the securities held in the account.

Various Practices Found During the Examination

Although the NMFBA programs provided by the firms were similar to each other, the firms differed in their approaches to administering, monitoring, and supervising the programs.

- One firm monitored each account on an individual basis to determine appropriateness of the program. This level of specific account review enabled the firm to better serve the customer and to determine the suitability of the program for each account holder. By contrast, most firms generated monitoring reports in the home office with a moderate level of review and limited customer contact.
- One firm required the customer to sign an agreement which included a full explanation of the terms and conditions of the account and a description of the type of customer for whom such an account would be suitable. In addition, there was a review by the branch manager of the customer's prior trading history to determine suitability before the customer could enroll in the program. By contrast, another firm only required that the accountholder answer four questions to determine if the account was suitable.
- All firms required that the account fee be paid on a quarterly basis in advance and some firms required that the customer be in the account for a minimum of one year.
- Upon termination of a NMFBA, two firms did not refund or pro-rate any fees even after the program had been determined not to be in the customer's best interest. One firm imposed a $500 closing fee if a NMFBA was terminated prior to its one year anniversary.
- Upon termination of a NMFBA within the first year, one firm imposed a transfer fee equal to 1% of the value of eligible mutual fund shares. This transfer fee was assessed on no-load shares. Charging a one percent fee acts a deterrent from terminating the NMFBA, even though it is in the customer's best interest to terminate it.
- Firms charged fees on mutual funds in the accounts on which the customer had already paid a front-end sales charge (load) or was subject to a contingent deferred sales charge payable to the broker if the customer sold the mutual fund shares before the end of a specified period. These mutual fund shares were intended to be held for the long term so that the customer could recoup cost of the front-end load or avoid paying the contingent deferred sales charge. They are, therefore, not suitable assets for a NMFBA.

Conclusion

Before placing a customer in a NMFBA, the securities salesperson must determine, and the firm must confirm, that such an account is suitable given the customer's needs. Once customers are placed in NMFBAs, firms must effectively monitor the accounts to determine whether the accounts remain suitable based on the customers' use of the accounts and take action on the accounts that are unsuitable. The Securities Division examinations found that customers were placed in NMFBA without regard to their past trading history or their probable future trading. As a result, customers were placed in NMFBAs when the program was unsuitable for the customer. The examination also found significant flaws in firms' supervision and monitoring of their NMFBA programs.

For information for investors about NMFBA programs see [Investor Bulletin]