Some Thoughts on the Brokerage Industry

By James B. Cloonan

I had the privilege of addressing the Securities Industry Association in New York recently. I expressed my feeling that for both the benefit of the retail customer and the health of the security brokerage industry, it was necessary to find a fee structure different from the existing one.

It is my feeling that the existing structure is driven by transactions, and it puts greater emphasis on stocks than other investment vehicles. It turns out that much of the audience shared my desire for a new fee structure. In fact, a large portion of the industry is looking for a more stable basis for fees.

Everyone also agreed, however, that any new fee structure would be a hard sell. Investors are used to transaction commissions, and it would be difficult to convince them to accept fees on any other basis. A large part of the brokerage industry, particularly the older established brokers, is also entrenched in the old system and would resist change.

The "wrap account" seems to be one solution to a change in Wall Street's fee structure. A wrap account is a program that provides investment advisory services and commission costs for a single fee, based on a percentage of the funds managed. While my comments two months ago about these new accounts may have seemed to some to be less than enthusiastic, I do like the idea. The structure and the price, however, are important, and it is on those two issues that I raised some concerns.

Unfortunately, the industry has not had a lot of success in selling the wrap account concept. I guess it is similar to the plight of "fee only" financial planners. They have a difficult time persuading clients to pay a fee because the clients feel they get the service free from planners who receive commissions. It is a sad part of life, I guess, that some individuals make it hard on themselves.

On the topic of a lack of understanding, I was reading the newspaper the other day and noticed the headline "Individual Investors Still Wary of Stock Market, Study Shows."

All of my experience indicates that individual investors, with a few exceptions, were not particularly hurt last October and have actually invested more in stocks recently. And, after a closer reading of the article that fell under the headline, I discovered that the survey was of investors who had difficulty with their brokers last October. What the survey actually said was that, of the 2,500 who had problems last October, 680 investors said they were still wary of the market.

While it is understandable that these individual investors would still be wary, it is a leap to assume all individual investors are "wary." More likely, the bulk of investors who are still wary are those who were hurt —individual speculators. The system should do what is necessary to protect individual investors. But not even God can protect individual speculators.

A friend of mine, in discussing the reduction in stock transactions and retail commissions, had a more cynical explanation.

Ordinarily, he said, individual speculators will lose their capital in an average of 20 transactions. In that time, the money will flow: one-third to long-term investors, one-third to the retail brokers, and one-third to specialists and market makers.

From the brokerage industry's viewpoint, the tragedy of the speculators losing all their money in one day was that 90% of their loss went to long-term investors and only 10% to retail brokers and specialists.

James Cloonan is president of AAII. His column is his own opinion, and does not necessarily reflect the views of the AAII Journal.