The New Broker Game

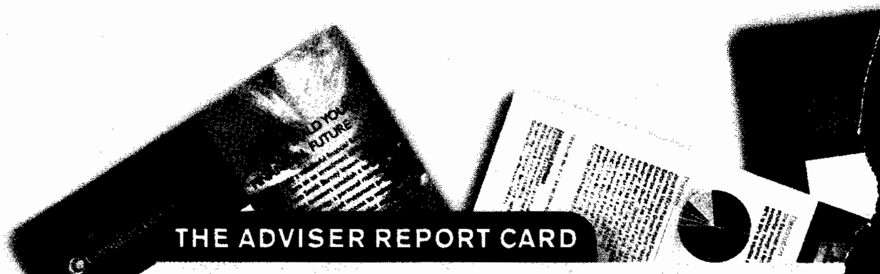
Big brokerages are working hard to refashion themselves as A-to-Z financial advisers. But when we went undercover as clients, we found ourselves surrounded by questionable advice, confused employees and much bending of the rules. A SmartMoney investigation.

By Dyan Machan

WE'RE SITTING IN A SUBURBAN TOWN IN NEW Jersey at the local Smith Barney office, a cube of concrete sheathed in shiny black glass. The broker across the desk is a fiftysomething who seems constitutionally sad. But he perks up considerably as we explain our dilemma: We're in desperate need of advice. We have a sizable chunk of cash and no clue what to do with it, and we need guidance on everything from estate planning to insurance to saving for our children's college education. Can he help us with all of it? "No problem," he says, leaning forward, his thick fingers spread across the table. "From A to Z, I can do it. There isn't anything I can't do."

Mr. Smith Barney explains that he wants to be the first person we call when we have any issues. He wants to get to know our family, too, he says, suggesting that he should be the first person they call if we, uh, die. He oozes concern for our welfare. So what does our new best friend offer us by way of advice? Membership in Smith Barney's AssetOne. This is a great

Illustrations by Thomas Reis



program, he explains: In return for 1 percent of our assets, we get a selection of mutual funds that have been handpicked by the firm's experts based on our risk profile. Granted, we probably could have found equally suitable funds using screening tools on any number of free Web sites without paying a fee, but it's considerate of our newfound soul mate to save us the trouble.

We're curious about his training. At one point we ask, "Are you a financial planner?" His reply, "Yes, I am," is followed by a long pause. He corrects himself: "Um, actually, I'm a wealth-management financial adviser." In fact, first and foremost he's a broker, trained to sell his own firm's products. And for all his apparent goodwill, that makes him part of a nationwide headache for investors like us.

Plenty of people lack the patience and acumen to manage their own finances; some simply lack the time. So as the clock ticks toward retirement for an affluent but busy generation, growing numbers of consumers are turning to investment advisers for counsel. Full-service brokerage firms are attracting new money from investors at a rapid pace; Merrill Lynch alone brought in $61 billion in new assets in 2006, a 15 percent increase. Cerulli Associates, a consulting firm that studies brokers, says that fee-based advisory accounts—a product popular with new clients—grew roughly 18 percent over the past three years, to $272 billion in the third quarter of 2006. And between 1995 and 2005, assets under the guidance of fee-only financial planners grew at an even faster rate.

But just when the need is greater than ever, finding someone who's qualified to give you a comprehensive plan has become unexpectedly complicated. Brokers, financial planners and registered investment advisers—some working independently, others for big financial-services firms—are competing to offer advice on everything from retirement planning to making nice with the tax man. Since 1999, when new rules allowed them to offer fee-based accounts, brokers have been particularly aggressive players, with more and more labeling themselves "financial advisers." Still, there's one particularly important difference among the competitors: Registered advisers and some financial planners are required to be fiduciaries—that is, to act in their clients' best financial interest—while brokers have no such duty.

THE ADVISER REPORT CARD

With brokerages expanding their role as financial advisers, we decided to test eight firms. We checked to see whether they strictly followed an SEC regulation that appears to prohibit brokers from selling financial plans. Then we evaluated their advice on life insurance and 529 college-savings plans. A "good" adviser would have recognized that we weren't appropriate candidates for either one. —D.M.

Banc of America
Fee*: 1.5% **Followed broker-dealer rule? No**
529 advice: Good **Life-insurance advice:** Bad
Favorite quote: "You won't find anything like our services."
We say: Wet-behind-the-ears broker asked few questions and seemed to inflate his credentials. **They say:** Didn't respond to calls for comment.

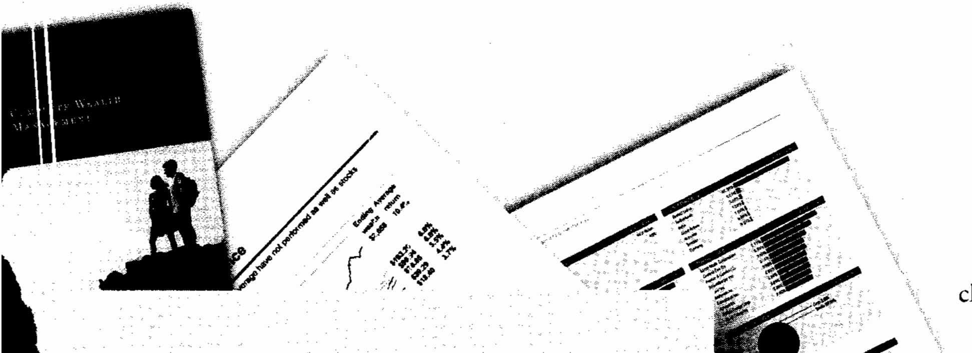
Charles Schwab
Fee: 0.5% **Followed broker-dealer rule? No**
529 advice: NA **Life-insurance advice:** NA
Favorite quote: "I'm happy to give you a brochure."
We say: For do-it-yourselfers only. Little effort to build a relationship or give advice. **They say:** It's appropriate to discuss financial planning with a prospective client.

Dreyfus
Fee: 1% **Followed broker-dealer rule? Yes**
529 advice: Good **Life-insurance advice:** Shrugged and gave us brochure.
Favorite quote: "Financial planners have thick glasses, and you wouldn't want to talk to them."
We say: Didn't oversell himself, but not particularly helpful either.
They say: Declined to comment because the branch we visited is now closed.

Merrill Lynch
Fee: 1% **Followed broker-dealer rule? No**
529 advice: Bad **Life-insurance advice:** Bad
Favorite quote: "I've always been a money manager."

*All fees are annual, as a percentage of assets. NA = Not applicable.

Because of that distinction, some advisers and consumer advocates argue that brokers shouldn't be allowed to offer fi nancial planning unless they have additional credentials. Und heavy lobbying from both sides, the Securities and Exchan Commission in 2005 came up with the "broker-dealer exc tion rule," known to some as Rule 202—a compromise seemingly hasn't satisfied anybody and has inspired an on



We say: Good investment knowledge but opaque about fees; pushed an expensive 529 plan. **They say:** The 529 and insurance advice was sound and insist they followed the broker-dealer rule because the company itself is licensed to offer plans.

Morgan Stanley
Fee: 2.25% **Followed broker-dealer rule? Yes**
529 advice: Good **Life-insurance advice:** NA
Favorite quote: "You buy the best doctor; why get cheap about your money?"
We say: Offensive attitude and high fees. **They say:** Agreed that the adviser's remarks were "inappropriate" and offered to discuss the issue with him.

Northwestern Mutual
Fee: 1% **Followed broker-dealer rule? Yes**
529 advice: Bad **Life-insurance advice:** Good
Favorite quote: "I manage your emotions: fear and greed."
We say: Informative and attentive while careful not to promise big returns or quick fixes. We'd hire him. **They say:** This particular rep had the correct credentials to offer a financial plan.

Smith Barney
Fee: 1.5% **Followed broker-dealer rule? No**
529 advice: Bad **Life-insurance advice:** Bad
Favorite quote: "529 plans have no fees!"
We say: Yes, they do, but the broker didn't seem to understand that. **They say:** Declined to comment on our experience and questioned our interpretation of broker-dealer rule.

Wachovia
Fee: 1% **Followed broker-dealer rule? No**
529 advice: Good **Life-insurance advice:** Good
Favorite quote: "Financial planners are not worth the money."
We say: Broker may have gotten rule wrong, but knew his stuff and asked lots of smart questions. **They say:** Broker shouldn't have used the words "financial plan" to describe what he was offering.

federal lawsuit. The rule allows brokers to keep selling broader advisory services. But it requires them to let clients know that hey aren't fiduciaries; it also says that in most cases, brokers *n't* sell soup-to-nuts financial plans or present themselves to nts as "financial planners."

Where does that leave investors? Still confused, and right-so. Comprehensive plans, after all, are exactly what many clients want—and maddeningly, the rule doesn't define what exactly constitutes a plan, leaving plenty of wiggle room for brokers. The tangle of rules helps explain why the National Association of Securities Dealers now lists more than 60 titles under which brokers can operate. "No investor will be sophisticated enough to know when the line is drawn—and when the financial adviser is acting outside the law," says Barbara Roper, director of investor protection for the Consumer Federation of America.

With all this in mind, SMARTMONEY decided to survey how well brokers are following these guidelines—and how well their advice would stand up under scrutiny. One of our reporters gathered a sampling of advice as a prospective client, visiting eight brokerages that were either within walking distance of our Manhattan office or within a short drive of her New Jersey home. She presented herself as a 48-year-old divorcée who had received a $250,000 legal settlement and needed advice about investing, tax and estate planning, college savings, retirement and insurance—all true, by the way. She left out only that she would be writing about the experience.

Of course, our field test wasn't scientific, and it was certainly geographically skewed. But our experience showed that in their new roles, many brokers seemed just as confused as their customers. We met would-be shepherds who ranged from the reassuringly authoritative to the disconcertingly green. We got contradictory advice that varied from the wise to the way off. We found out that a high proportion of our advisers couldn't explain what "fiduciary duty" was. And while some firms disagree with our interpretation of the rules, five brokerages made promises that seemed to violate one key regulation. The good news: We picked up a lot of attractive graphs and pie charts, and a couple weeks' worth of free coffee.

NO BROKERAGE TOUR WOULD BE COMPLETE without a visit to Merrill Lynch, which employs 15,000 brokers nationwide, more than any other company. We drive to its franchise in an office park in Paramus, N.J., where we're ushered into a no-frills meeting room, near a field of cubicles where staffers sit glued to their screens. The young and unctuous financial adviser as-signed to us is all smiles. He promises the "whole umbrella" of possible financial services, including the company's Financial Foundation. It's a thick document that covers everything from investment planning and life insurance to wills and trusts, and our adviser describes it as the very same tool for which financial planners charge $1,000. Normally, Merrill Lynch charges $250 for it, but for us, our adviser beams in a one-day-only-sale voice, "it's on the house."

Our broker's employer lobbied so hard for the broker-dealer exception that many in the financial-services industry call it the Merrill Lynch rule. So it's no surprise that he's bending it as far as it can go by pitching a financial plan. Merrill Lynch says that its broker acted properly because the company itself is registered as an investment adviser. Critics cry foul at that interpretation: Steven Caruso, the president of the Public Investors Arbitration Bar Association, says no broker should offer financial plans unless he or she personally is a registered investment adviser. Who's right? Robert Plaze, associate director of the SEC's investment management division, says that in general, there's nothing wrong with a broker offering us a plan. But he adds that if we actually signed up to *accept* a plan from a broker, that broker could be violating the rules. "It's very confusing," Plaze admits. No kidding. And not just for us: Of the eight brokers we visited, five offered us financial plans even though, by critics' standards, they weren't qualified.

In any case, the Financial Foundation wasn't all that our Merrill adviser had to offer. He suggested that we place $100,000 in a municipal bond fund and the balance in a diversified stock portfolio, at a 1 percent fee. A bit conservative for someone our age, but the recommendation and price were decent. We couldn't say the same for the advice we got about a different pot of money, the funds we're saving for our twin 16-year-old sons' college education. We were urged to buy a 529 savings plan—not a great move, since our sons are less than two years away from college and don't have time to take significant advantage of the plan's tax-free earnings. And although we live in New Jersey, where the "NJBest" 529 program would let us invest in Franklin Templeton mutual funds that charge a 1.11 percent annual fee, our adviser steered us elsewhere. "New Jersey's program is very bad," he said, adding, "you don't want it." Maine's NextGen program, on the other hand, which also uses Franklin Templeton, "is very nice."

In fact, both plans get the same rating from the independent Web site SavingforCollege.com, though Maine's annual fees are slightly higher. More relevantly, Merrill has a fee-sharing sales arrangement with Maine and none with New Jersey.

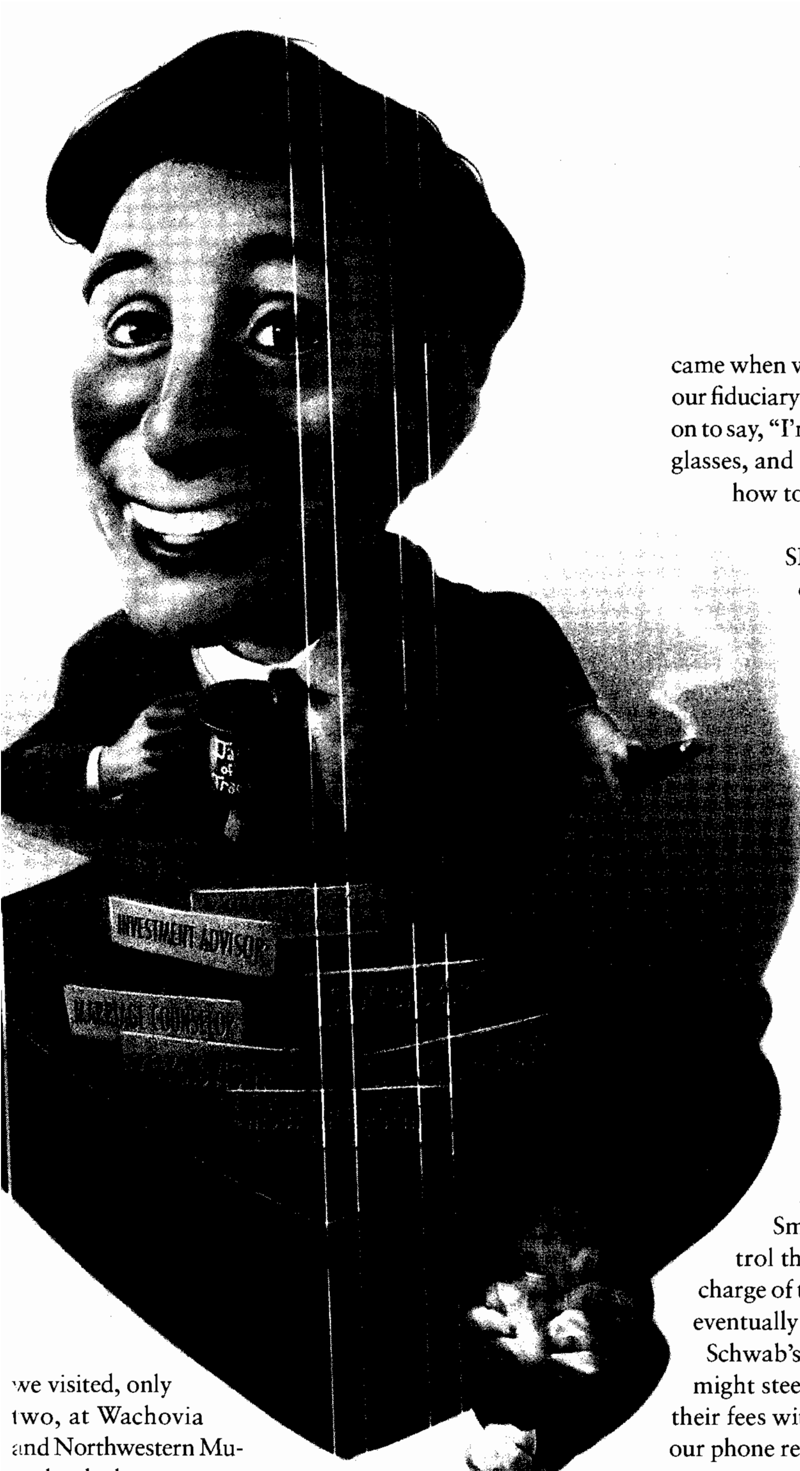
The securities industry has been rife with complaints about

Many brokers **were eager to give us a financial plan. But critics say that brokers who offer those services are breaking the rules. Even the SEC seems unclear about who's right. One tip for avoiding confusion: Find advisers who are legally obligated to put your interests first.**

the way it sells 529s. An NASD survey found that more than 90 percent of sales by some brokerages were made to out-of-state residents, even though such arrangements are often more costly. Merrill says that the firm has "sound, objective reasons" for offering Maine's plan over New Jersey's. But the incident illustrates a relevant point: Under the law, brokers need only to find you a "suitable investment." It doesn't matter if it's not the best or most cost-effective one. Whatever the state, buying a 529 through Merrill would have cost us an upfront sales load of 5.75 percent of our college savings, a good-size chunk of freshman-year tuition.

THEY DON'T GET MANY "WALK-INS" ON the seventh floor of Manhattan's General Motors building, where Banc of America Investment Services keeps offices. We wait in the East Meadow Room, part of a soothing, Asian-inspired space with plush chairs and smoked-glass walls. When the on-call broker du jour arrives, he greets us with a big smile and firm handshake. Making small talk, he volunteers that one of his relatives works for a famous rapper. But as soon as we begin talking about investing, he starts sweating visibly. He's a recent college graduate who just moved to town from the Southwest. Presumably, we'd be talking to a veteran if we'd shown up at the door with a million dollars. But if we had a million dollars, we probably wouldn't be a walk-in: Brokers tend to land their highest-asset clients through personal connections and referrals.

We try to help our Doogie Howser broker by taking the initiative on the Q&A. Do we need life insurance, we ask? "Definitely," he replies. He disappears for 15 minutes, returning with an insurance expert who seems only slightly more seasoned. Together, they solemnly conclude that we need more coverag
Oops. In fact, because of financial provisions our family ha
already made, that's exactly what we *don't* need—somethi
they might have figured out with just a couple of questio
But while these gentlemen may be young, they're hardly
only ones to point us in the wrong direction. Of the br



we visited, only two, at Wachovia and Northwestern Mutual—the latter, a company best known for selling insurance—deduced that we weren't a good life-insurance candidate.

We ask our broker if he can explain fiduciary responsibility. He goes the spelling-bee route and uses "fiduciary" in a sentence: "Sure, it's that I have a fiduciary responsibility to keep this confidential," he says. (We shouldn't feel too bad about not knowing what the word means, he implies; after all, we love educating our clients.") In missing the mark on this finition, Doogie has plenty of company. Asked what it meant be a fiduciary—in other words, to put the client's financial rests above his firm's—every broker but one either botched swer or evaded the question. The most candid answer came when we asked a gentleman at Dreyfus whether he was our fiduciary: "No, but I play one on TV." This comedian went on to say, "I'm not a financial planner. They all have these thick glasses, and you wouldn't want to talk to them. But I know how to manage money."

Precisely because brokers aren't fiduciaries, the SEC's Rule 202 requires them to make a very specific disclosure in their client enrollment forms. The disclosure should essentially say, *Your account is a brokerage account and not an advisory account. Our interests may not be the same as yours. Please ask us questions to make sure you understand.* To their credit, all of our brokers had the disclosure posted somewhere on their Web sites. None, however, went out of their way to bring it to our attention. And when we took the rule literally and posed questions, asking what it meant that their interests weren't the same as ours, they generally fumbled the ball. It's perhaps not surprising that nobody gave us the straightest answer: that, given a choice between recommending Investment A or Investment B, they have a legal right—and a strong incentive—to push the one with the bigger commission.

Some brokers responded to the question by reminding us that they wouldn't be responsible if our investments went south. For example, our Smith Barney broker: "That just means you control the assets," he says authoritatively. "I am not in charge of the decisions." (Reassuring!) Only one company eventually offered some straight talk. The folks on Charles Schwab's customer-service line admitted that our broker might steer us toward mutual funds that shared more of their fees with the broker. "We try to put clients first," said our phone rep, "but we operate for a profit."

EVENTUALLY, WE COME ACROSS SOMEONE legally qualified to give us comprehensive advice. We find our Morgan Stanley broker through the company's 800 number and meet him in a luxurious, wood-paneled office near Manhattan's Penn Station. He's a balding man in his mid-30s, a relentless talker, a locomotive in his own right. He's also a registered investment adviser, which means that Rule 202 doesn't hold him back. His rapid-fire observations are generally more sophisticated than anything we've heard. So it's too bad that they're delivered with a heavy dose of condescending sexism. For instance, he assumes that our lump-sum settlement is divorce-related, though we've never

Picking an Adviser

The "financial adviser" label fits an army of experts with a bewildering range of titles. But whether you're considering hiring a big brokerage or a neighbor who works out of her garage, some of the same tips apply. Below, a newcomer's guide. —D.M. and Megan Barnett

★ **KNOW WHAT YOU WANT.** A person who wants basic investment guidance has different needs from someone looking for help on everything from taxes to estate planning. If you're comfortable managing your own money, for example, you may want to meet with a financial planner who charges an hourly rate and can give you a "road map"; if you need more handholding, a full-service brokerage or a large financial-planning firm might serve you better.

★ **HOW ARE THEY PAID?** Insist on full disclosure of where your prospective adviser's compensation comes from and how much you'll pay each year. Some advisers earn commissions or incentives based on the products they sell. Others charge flat rates, hourly rates or annual fees of a percentage of your assets. The fee-based models aren't always the cheapest: Someone who doesn't trade often may be better off paying commissions, says Duane Thompson, managing director of the Washington, D.C., office of the Financial Planning Association.

★ **BE THE CSI CUSTOMER.** You can determine what your would-be counselor's titles mean at *www.cfp.net/learn.* (Click "Terminology and Credentials.") Patricia Struck, former president of the North American Securities Administrators Association, suggests that you ask for references from other clients. If you're considering hiring a broker, find out whether he has ever been disciplined by going to *www.nasd.com* and clicking "BrokerCheck," or by calling 800-289-9999.

★ **CALL THEM TO ACCOUNT.** Before you sign on with a brokerage firm, find out whether you'll have an "advisory" account, overseen by a registered investment adviser. In such an account, the adviser has a "fiduciary duty" to you, meaning she has to put your financial interests ahead of her firm's profit motive. A standard brokerage account isn't held to the same obligations.

★ **LOOK FOR A GOOD FIT.** In the end, picking an adviser can come down to chemistry. Shop around for someone whose values and investment style match yours, and bring your spouse along. And for every question you ask, an adviser should ask you a dozen about your true financial health, history and investment needs. Time-consuming? Sure, but it takes in-depth information to deliver a comprehensive financial plan that actually works.

said so. "Your former husband will only pay you alimony until he meets a 24-year-old blonde!" he says knowingly.

He advises, rightly, against a 529 plan—although his proposed alternative, an UGMA (uniform gift to minors account), has drawbacks of its own—not least that the kids can do whatever they want with the money once they turn 18. Like the rest, he plans to invest our nest egg in a dozen mutual funds, offering a list of 200 from which we would pick. When we argue that we could find funds ourselves, he retorts, "You can buy your own drugs, too, but it pays to see a doctor." But this doctor's formulary includes only funds with which the brokerage has a fee-sharing arrangement. That means we can't buy the usually dirt-cheap Vanguard 500 Index without paying an added fee; instead, we can opt for a Morgan Stanley index fund whose expenses are three times as high. Voilà: the price of expertise.

When we eventually sit down with our notebooks and handsome handouts, it's clear the advice we've received has ranged all over the map. Smith Barney thought we should have 95 percent of our assets in equity-only mutual funds. Merrill Lynch advocated 56 percent. Wachovia thought covered calls were a good idea. The fees ranged from 0.5 percent of our assets at Charles Schwab up to 2.25 percent at Morgan Stanley—and that doesn't include the upfront sales loads on some of the products the brokers recommended. In all, three brokerages tried to sell us out-of-state 529 plans that gave them a cut of the fees; only three deduced that we didn't need a 529 at all. And nobody explained the clear difference between being a fiduciary and being, well, a broker.

A survey of 1,000 investors last year by TD Ameritrade found that 74 percent were unaware that stockbrokers and registered investment advisers had different levels of legal responsibility to their clients. The SEC recently hired the researcher RAND Corp., paying it $787,000 to study whether, in fact, consumers are confused by this situation. With all due respect, we think we could save taxpayers some money and the RAND folks some time. Ⓢ

Additional reporting by Megan Barnett

▶ SmartMoney.com

Senior writer Dyan Machan tackles the SEC's confusing broker-dealer rules, at www.smartmoney.com/tv.