STATE OF WASHINGTON
DEPARTMENT OF FINANCIAL INSTITUTIONS
SECURITIES DIVISION
P.O. Box 9033 ● Olympia, Washington 98507-9033
Telephone (360) 902-8760 ● TDD (360) 664-8126 ● FAX (360) 902-0524 ● Web Site: www.dfi.wa.gov/sd

Investor Bulletin

Investors have a number of choices for investment advice. Investors also have many choices for brokerage accounts. In order to make an informed choice, investors need to know the types of accounts available and the fee structures for those accounts. An investor also needs to know the contents of his or her investment portfolio, the amount of trading he or she typically does, and the type of services he or she wants to receive.

Many investors are overwhelmed by the number of choices for investment advice and brokerage services. One report, based on a study conducted by the Rand Corporation on behalf of the U.S. Securities and Exchange Commission ("SEC"), found that many investors are confused about the differences between broker-dealers and investment advisers. The report found that investors, even experienced investors, were confused about the services broker-dealers and investment advisers provide, and about the standards of care to which each are held. A pre-publication version of the Rand report is available on the SEC's website at http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf.

It used to be easy to tell whether you were dealing with a broker-dealer or an investment adviser. In the past, an investment adviser charged a fee for advice. A broker-dealer charged a commission, markup, or markdown for each transaction it executed in a brokerage account. Things are no longer so simple. The financial services industry now offers many different options for paying for investment advisory and brokerage services. These options include bundles of investment advisory and brokerage services.

With all the choices available, an investor needs to take a hard look at what investment advice or brokerage services he or she really wants or needs and how much he or she is willing to pay for it.

- For example, if the stock market is your hobby, and you spend a lot of time researching stocks, it may not make sense for you to pay for ongoing portfolio management services. An investment adviser charging an hourly rate might be a better deal if you decide you want some professional investment advice from time to time. It also might make more sense for you to use a discount broker instead of paying the higher transaction costs of a full service broker.
- On the other hand, if you do not have the time to research the stock market yourself, you might be willing to pay a percentage of your assets in order to have someone else manage your portfolio for you. If so, do you want to pay for your portfolio management and brokerage services separately or do you want to pay for them in a bundle, such as a wrap fee?

Some broker-dealers also offer fee-based brokerage accounts that do not include investment advisory services. These are called Non-Managed Fee-Based Accounts ("NMFBA"). As an investor, how do you decide whether you would be better off in a fee-based account, like a NMFBA or a wrap account, or in a commission-based account, where you pay commissions, markups, or markdowns based on each transaction? To answer these questions, you need to look closely at your past trading patterns and your probable trading needs in the future.

What Kind of Brokerage Account is Best for Me?
To decide whether a fee-based brokerage account, such as a NMFBA or wrap account, or a standard commission-based account is a good choice for you, there are several factors to consider. Some factors include the frequency of trading, the experience and sophistication of the investor, the desired level of asset allocation and/or portfolio management service, and the types of assets in the account. Other factors to consider include: the expected time in the program, whether the program has a required enrollment period, the amount of the fees, whether the program requires fees to be paid in advance, the program's termination penalty, and whether there are termination fees. DFI has looked at NMFBA programs in practice, and it has some concerns about how brokerage firms supervised those programs. See DFI's report on its NMFBA examination sweep. [link to report]

The following chart highlights some of the differences between NMFBA programs and commission-based programs:

	Fee-based accounts	**Commission-based accounts**
How fees are charged	Fees paid based upon assets in account	Fees paid based upon trades made in account
When are fees paid	Quarterly, in advance	When trade occurs
Benefits	• Lower cost for active traders • Easy payment method • Reduced likelihood of account churning	• Lower cost for inactive traders • Fees charged for services provided • More likely to have broker pay attention to account

A NMFBA may be beneficial for investors who trade heavily, pay high trade commissions on a regular basis, and do not need asset allocation or portfolio management services. However, brokerage firms usually limit the amount of trading that customers may do in NMFBAs. On the other hand, investors who do not trade often in their accounts may be better off in a traditional commission-based account.

A wrap account may be beneficial for an investor who wants investment advisory services, which includes asset allocation and portfolio management services. Both NMFBA and wrap fee accounts charge an annual fee that is typically paid at the beginning of each quarter and some firms do not refund or prorate the fees if you terminate the account before the end of the period. Therefore, it is important to be sure that the account is suitable for you before you enter into it. Here are some questions to ask if you are considering switching to a fee-based brokerage account:

Questions to Ask of Yourself and Your Broker

Questions to ask yourself about your trading patterns and preferences:

- How often do I buy and sell securities in my account?
- How much do I pay in commission-based fees currently?
- How much would I pay in fees if I switched?
- What type of securities do I have and what do I intend to purchase?
- If I prefer a quarterly fee, which is best for me, a NMFBA or a wrap account?
- Am I looking for asset allocation and portfolio management services?

Questions to ask your broker when considering a NMFBA:

- Under what circumstances can the brokerage terminate my NMFBA for excessive trading?
- Is there a minimum time period that I must keep my NMFBA account open?
- Is there a fee for terminating the NMFBA?
- If I were to open a NMFBA, what information will the broker provide me regarding what I would have paid if I had a commission-based brokerage account? (The amount you would have paid if you had a commission-based account is sometimes called suppressed commissions.)
- If I close my account, will the broker refund or prorate any prepaid fees?

For more information about NMFBA, please contact the DFI Securities Division at (360) 902-8760 or visit www.dfi.wa.gov.