FPA Financial Planning Association
The Heart of Financial Planning℠

Consumer Tips on Buying Stocks and Bonds Owned by Your Broker's Firm

Not all stocks and bonds are created equal on Wall Street. A particular stock or bond that is identical to another may be treated differently by your brokerage firm, depending on whether the firm owns the stock or bond in its own account.

Trading from a firm's own inventory, known in the business as a "principal trade," may pose increased risks to the investor beyond the normal risks of investing in the stock and bond markets.

There is nothing wrong with principal trading. In fact, the law requires that your broker recommend to you only "suitable" transactions and find you the best possible price when executing any transaction. However, principal trades represent a unique conflict of interest for the broker. Generally, the brokerage firm receives a greater benefit by selling to you out of its own inventory for a variety of reasons. The firm may have received a discount in purchasing a large set of bonds and will profit from the markup in selling them to you, as opposed to selling you the same bond from the open market. In a worse case scenario, the firm may recommend that you buy stocks or bonds that it does not want because of a potential decline in value. In recommending these shares to you, it would be engaged in the harmful practice of "dumping." So even if your broker recommends a principal trade that is "suitable," it is not necessarily what is "best" for you.

The rights you enjoy as an investor may depend on whether you hold a brokerage or advisory account. **If you are simply paying your broker a commission for making trades, he or she doesn't need to tell you in advance if the stock or bond is coming from the firm's inventory. But if you are paying a fee based on assets, and receiving investment advice, the law requires the broker/adviser to disclose this potential conflict and requires your advance approval.**

Broker or Adviser?

Traditionally, principal trading activity was subject to broker rules (see back side for details). However, in the late 1990s as brokerage firms began to charge fees instead of commissions for their advice, the rules began to change. Brokers began using titles like "financial adviser" on their business cards and brokerage firms ran ads on TV suggesting they always put their clients' interests first. This legal requirement to put the client's interests first is true only when the firm is also registered as an investment adviser, and only for their advisory, not their brokerage accounts.

As these new financial advisers began charging fees for their advice, the question over whether they were required to act in the client's best interest was challenged in court by the Financial Planning Association® (FPA®), which supported greater protection for investors. As a result of a March 30, 2007, federal court decision, brokers who charged a fee for advice are now required to place their client's interests ahead of their own and to be licensed as investment advisers.

In light of the court decision, a rule was put into place on Sept. 30, 2007, allowing these new broker/advisers to streamline the process for obtaining your consent to conduct certain kinds of principal trades. FPA believes that it is important to understand how principal trades work, and to ensure that your broker/advisor is truly acting in your best interest, not the firm's. We recommend that you learn not only about the benefits, but the risks involved in principal trading. The new rules affecting principal trades are summarized on the back of this page.

What is a Principal Trade?

A principal trade, or transaction, is when your broker or adviser sells stocks or bonds to you from their firm's own inventory, instead of buying and selling in the open market.

Know Your Rights When Approving Principal Trades

If you pay a fee for investment advice to your broker/adviser, and you are asked for your consent to engage in principal trading:

- Your broker should also be registered as an investment adviser and should act solely in your best interest. Ignore the ads and glossy brochures that tout the firm's loyalty to you. Ask them if they are legally bound to act in your best interest, and persist until you get a straight 'yes' or 'no' answer.
- Your broker/adviser should disclose the nature of the conflicts arising from principal trades. **If you don't fully understand the disclosure, ask questions.**
- You can refuse to have your broker/adviser engage in principal transactions.
- You can revoke your general consent to enter into principal transactions at any time, but you must do so in writing.
- If you allow your broker/adviser to engage in principal transactions, your oral consent is still required before each trade is undertaken.

Keeping Alert for 'Dumping'

Dumping a worthless stock or bond, or one declining in value, remains a significant concern to federal regulators, and is the primary risk with principal trades. Here's how to look out for dumping by a dishonest broker/adviser.

- Keep copies of all principal trade transactions, typically called sales confirms or confirmations. Take notes on buy or sell recommendations by your broker/adviser and his or her firm, and any principal trades that were made on your behalf.

- At the end of the year, your broker/adviser is required to give you a summary statement of your principal trades. You should check the price at which the trade was made and the current price of the stock or bond. If the price has dropped, it may have occurred because the overall market dropped, which is a common risk for investors. But you should also be alert to dumping if you detect a pattern of 'buy' recommendations from your broker/adviser and these same stocks and bonds, made through principal trades, later dropped in value.

- If the principal trading resulted in consistent losses over the past year, ask your broker/adviser if his or her firm has an in-house analyst who made the recommendation to you, or if it came from an independent analyst. If the advice was generated in-house, ask your broker/adviser for any changes to the firm's recommendations after you traded, even if the changes were made months after your trade.

- If you notice a pattern of downgrading stocks or bonds from a "buy" to a "hold" or "sell" recommendation after principal trades were made on your behalf, then you may be a victim of 'dumping' of devalued stocks or bonds held by the firm. If you believe that you are a victim of dumping, you may want to contact the SEC or consider retaining an attorney to examine your legal options.

Broker Rules Covering Principal Trades

Brokers can continue to conduct principal trades for their brokerage customers, according to long-standing brokerage rules. These rules require:

- The trade must be suitable to the customer's investment objectives;

- The broker must promptly execute the trades that you initiate; and

- The broker must provide a 'sales confirm,' or slip of paper indicating that the firm acted as a principal in the transaction, the number of shares, and the price and time of the trade.

New Adviser Rule for Principal Trades

Under the new SEC rule, before undertaking each principal trade in your account, your broker/adviser must tell you (orally or in writing, including e-mail) that he/she may act as principal on the trade and must obtain your oral or written consent. In addition, as of January 1, 2008, your broker/adviser will be required to send you a written explanation of the circumstances under which he/she may engage in principal trading in your account and the conflicts of interest this may pose. They must also obtain a one-time written consent from you, which you may revoke at any time.

Following each principal transaction, your broker/adviser will need to send you a confirmation statement disclosing that it has acted as a principal and that you authorized the trade. You should also receive an annual report itemizing all principal transactions and the dates and prices of such trades.

Note that these new requirements apply only to "non-discretionary" accounts. In instances where your broker/adviser has the authority to buy and sell securities for your account without consulting your first, different principal trading restrictions apply.