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Will New Rules Stop Brokers From Nibbling on Your Returns?

By Jason Zweig

Brokers' charges might—just might—be about to drop. But you shouldn't drop your guard.

The Financial Industry Regulatory Authority, which oversees the brokerage business, is seeking to modernize its decades-old standards for judging whether transaction costs are appropriate.

Intended to clarify the murky realm of trading costs, the changes might not be uniformly positive. Finra hopes to alter a rule interpreted by some brokers to mean that transaction charges of up to 5% aren't excessive. But the regulator also is seeking to scrap a provision that restricts brokers from charging two commissions on linked buy-and-sell transactions.

Many investors think of the broker's commission as the cost of buying a security, but that is just the beginning. Your brokerage firm may act as a "principal," selling you securities it already holds. If you are buying, a principal can charge you more for the security than it paid; this take is known as a markup. If you are selling, the firm can buy from you for less than it could resell the security for; that vigorish is called a markdown.

Finra has long held that markups generally should be 5% or less. That, unfortunately, has led many brokers to assume that any cut of up to 5% is acceptable.

Consider $600,000 (par value) of bonds issued by the Port Authority of New York and New Jersey. On the morning of May 8, 2009, a municipal-bond investment manager bid to buy them at 104.43, and was outbid by another firm at 104.75,according to an executive at one of the firms. Yet the bonds never traded at that price.

That is because another firm bought the bonds—presumably from an investor who was unaware of any competing bids—at 102.499, according to trading records available at www.investinginbonds.com. Just three hours later, the firm had unloaded all the bonds at 106.799, a 4.2% markup. That was the only change in their price that day.

"I don't see how you could say this egregious markup was needed as compensation for risking the broker's capital," the investment manager says.

More recently, on March 16, a firm bought $25,000 in New York State Environmental Facilities Corp. municipal bonds at 109.797. Almost immediately, the firm flipped them at 112.797, a 2.7% markup. That is how firms get paid, but such a transaction is virtually riskless.

Marc Menchel, Finra's general counsel for regulation, declined to comment on the specifics of these trades. In general, however, "we would take the view that a 4% markup is overly rich," he says. "A broker cannot defend a markup on the basis of yield alone. You still have the duty of fair pricing."

Finra would replace the 5% guideline with general principles of fairness—and will likely be setting "bands of scrutiny" well below 5% where "we're going to be looking hard," Mr. Menchel says.

Finra also is proposing to drop the "proceeds provision," which deters brokers from charging two commissions when a client sells one investment and promptly buys another. Such double-dipping can occur in rapid-fire trades, also called "churning," or on less-frequent transactions.

Scott Beall, an attorney in Memphis, Tenn., represents a client whose broker repeatedly sold one stock and replaced it with another—charging commissions both ways totaling up to 8% of the value of the trade, Mr. Beall says. The broker often replaced one stock with a nearly identical one on the same day, Mr. Beall says—leaving the portfolio essentially unchanged, but generating thousands in fees. "There's got to be some kind of line here to protect investors," he says.

Finra contends that it is often unclear whether the sale of one security and the purchase of another are directly related. "We're uncomfortable with the idea that, as a matter of regulation, a broker-dealer is not entitled to be paid for both sides of a two-sided transaction," Mr. Menchel says.

Ultimately, investors may have to take matters into their own hands. Seth Wittner, 60 years old, a physician's assistant near Las Vegas, paid a 3.6% commission to buy 100 shares of Wal-Mart Stores in the self-directed brokerage window of his 401(k) plan. "I complained to the broker," then at Morgan Stanley, "and he said he was giving me a price break," Mr. Wittner says. "God knows what he thinks full price is." (Morgan Stanley responds: "We believe our commission rates and structures are in line with other full-service brokerage firms.")

Mr. Wittner told his broker he wouldn't pay more than $50 in commissions on his next trade—and, he says, the broker agreed.

The lesson: Regardless of how regulations might change, investors must protect themselves from getting chiseled.

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Corrections & Amplifications Marc Menchel is the general counsel for the Financial Industry Regulatory Authority. His last name was misspelled as Menshel in a previouos version of this column.

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