

AVERAGE INVESTOR BE DAMNED

MARCH 2006

Over the past five years we have reported on many of the nefarious practices put into play by the big brokerage firms in order to further their long-term goal of ridding themselves of “*small investors*” to boost the bottom-line. Dumping on the small investor has not only become policy for some firms, it has also become a profit center. Whether it is being shipped off to “*Call Center Hell*,” being used like a lab rat for some experienced broker to practice on, or sold some high priced annuity/insurance product, investors with under \$250,000 in their accounts, beware, you are in their crosshairs.

The NASD announced this past month that it has fined the ridiculous amount of \$5 million for supervisory failures, registration violations, impermissible sales contests and other violations dealing with what we dubbed “*Call Center Hell*” in the November 2005 issue of the *Markowski Monthly*. The firm was also prohibited from staging any sales contests for the personnel of “*Call Center Hell*” for three years.

NASD Senior Vice President and Acting Head of Enforcement James Shorris stated...

“Regardless of the size of their brokerage account, all investors are entitled to services from registered representatives acting in their clients best interests who are reasonably supervised by properly registered professionals. In this case Merrill Lynch failed to meet these basic standards by permitting its call center to function without proper supervisory controls, which gave rise to impermissible sales contests, unsuitable mutual fund switches, and other systemic failures.”

The NASD found that, Merrill Lynch did not have a supervisory system that was capable of overseeing the trading activities of its inexperienced broker’s at the call center. Merrill Lynch didn’t give them the title of broker at the center; these inexperienced rookies were given the moniker of Investment Service Advisors (ISAs). I guess ISA had a better sales appeal than the more appropriate designation anal-sphincter.

ISAs (*anal-sphincters*) according to the NASD report, engaged in a pattern of mutual fund switch recommendations or what we call churning for commissions, which were accompanied by misrepresentations and omissions of facts to customers. In a classic example of the blind leading the blind, Merrill Lynch allowed individuals lacking the proper securities licenses and qualifications to be responsible for the supervision of the ISAs. Merrill Lynch also conducted sales contests which awarded non-cash compensation to ISAs in the form of rock concert tickets, sporting events and dinners based solely on one’s ability to churn clients into the firm’s proprietary mutual funds.

“*Call Center Hell*” (CCH) was born out of Merrill Lynch’s desire “*to improve its retail business by segmenting customer accounts.*” (Sounds like something out of *Mein Kampf*.)

Translation: “*Let’s round up all of our small piker accounts that do not generate enough in commission dollars and ship them off to be used as target practice by our know-nothing rookies to be churned into oblivion.*”

Their plan worked brilliantly. The NASD found that between March 2001 and August 2002, more than 1 million customers were transferred to CCH. At its peak size in 2002, CCH had approximately 1.3 million accounts holding approximately \$20 billion in assets. That year, CCH had gross revenues of approximately \$210 million.

All of the unsuspecting victims of Call Center Hell were told they would receive “*around the clock customized advice from a team of Merrill Lynch professionals.*” Reality was poles apart.

The NASD found that Merrill Lynch failed to disclose that the anal-sphincters (ISA's) often had five years or less of brokerage experience, and that when making recommendations regarding securities, they were limited solely to proprietary mutual funds. ISA's solicited thousands of trades from their new victims as soon as they were transferred, generating millions of dollars in commissions for the Lucifer of CCH, Merrill Lynch.

I think the young ISA's of CCH were pulling out all the stops in order to impress their underworld master by trying to get themselves in the Guinness Book of World Records for churning. In one week in March 2002, there were approximately 1,324 mutual fund switches. Moreover, the NASD found that many of the trades were not suitable for their customers. Financial planners have a fiduciary responsibility before making a recommendation; to consider whether a mutual fund switch is prudent and if a change is deemed necessary. For example: Are there free-exchange or lower-cost alternatives available? Representatives of *Call Center Hell* were only moving victims into the high-cost proprietary Merrill Lynch funds. The NASD also found that, in connection with the unsuitable switches, many of the ISAs made false representations to customers, and/or omitted material facts, concerning costs and other important information.

The NASD also noted that Merrill Lynch also failed to employ a supervisory system and procedures reasonably designed to supervise the ISAs. For example: Merrill Lynch's form "switch letters" sent to customers were often inaccurate. Specifically, the letters represented that the administrative manager signing the letter had discussed the mutual fund switch with the ISA to confirm that all of the proper disclosure of costs had been made to the customer. In reality these letters were mass printed and the administrative managers rarely discussed this issue with the ISA before sending the switch letters.

Brokerage firms fail to employ adequate supervisors on purpose. If and when they are caught for their misdeeds, they have an excuse. Whenever firms are caught they blame it on a failure to supervise and swear up and down that they are going to rectify the situation with reforms. The whole thing is a set up from day one. Brokerage firms are well aware of what they are doing. The Lucifer of Call Center Hell, Merrill Lynch only employed three to six sales managers to manage 300 ISA's conducting thousands of trades a day, with the majority not properly registered as securities principals. The playbook says...Blame the compliance officer and back to business as usual.

In order to lighten up the mood and increase moral of the ISA's in *Call Center Hell* Lucifer would hold churning contests. The ISAs that convinced the most victims to switch their mutual funds to proprietary Merrill Lynch funds were awarded various prizes. NASD rules and just plain ethical behavior prohibit non-cash compensation arrangements between firms and their brokers for sales of mutual funds and variable contracts that are not based on concepts of "total production" and "equal weighting." In other words, the contests must be based on total sales of all products within a single category, such as mutual funds.

The NASD found that the firm offered and awarded various forms of non-cash compensation to the contest winners. For example, one contest rewarded the six ISAs who sold the most proprietary mutual fund products with tickets to a rock concert. Another offered a total of \$10,000 in expense credits to the top four teams of ISAs in total of proprietary product sales. The NASD found that these contests contributed to a dramatic increase in the volume of proprietary mutual fund sales by CCH. For example, in the first half of 2002, gross sales of proprietary products increased from \$36.4 million in the first quarter to \$138.7 million in the second quarter, a 300 percent increase.

This case is another example of how white-collar crime does pay for the large investment houses. Merrill Lynch (Lucifer) was fined \$5 million and neither admitted or denied wrongdoing for operating *Call Center Hell*.

Two of the many things I find appalling about this case are first, the complete lack of any real punishment and second, the complete lack of media coverage.

The NASD fined Merrill Lynch a lousy \$5 million. A company that did over \$13.5 billion in revenue last quarter, a firm that systematically rounded up its "poor" clients to have them churned into oblivion was fined a pittance. What is worse is the complete lack of media coverage of this story. If a small business in Anytown, USA happened to be accused of discrimination or favoritism to wealthy patrons, it would be the headline story in the *USA Today* and the top story on *The Today Show*. The fact that we are the only entity covering this story once again articulates and furthers my contention regarding the buying and selling of the media.

Total Merrill...More like Total Bull\$%#@.

Lucifer is spending millions on its brand new Total Merrill advertising campaign, and the media wants those millions. A nasty story like this wouldn't exactly be the greatest lead in for the next commercial break. The last thing the press wants to do is to upset Lucifer and his deep pockets. Have you seen the stock price of many newspaper companies lately? Ouch!

In a related story, this past year Merrill Lynch and Morgan Stanley initiated a program where brokers were no longer paid on accounts that had less \$50,000 and \$35,000 respectively thereby eliminating any incentive for the broker to help an existing client. The firm continued to make money on the fees from the mutual funds and the client was for all intensive purposes placed in solitary confinement. Clients were not notified of this policy change.

We are seeing an alarming but not surprising amount of investors coming to us with stories of getting very bad advice or facing downright offensive behavior at the big wirehouse firms. We are encountering a lot of bad behavior from big banks where investors are being pitched many inappropriate high commission products. Wall Street is telling the little guy (meaning just starting out to \$250,000) to take along walk off a short pier. "Small investors" are now left with the unpalatable option of either buying some high commission annuity or insurance product being a crash-test-dummy for an inexperienced broker.