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4 Dishonest Broker Tactics And How To Avoid Them

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Any industry has its bad apples, and the brokerage industry is no exception. While most investment professionals are honest, there are always people who will take advantage of people when given the change - especially when it comes to money. As a result, it helps to be armed with information to help you understand the investment profession, and ask the right questions when seeking its services.

For the most part, the Securities and Exchange Commission (SEC) and National Association of Securities Dealers (NASD) do a fairly good job regulating and policing the brokerage community. Even so, the best way to avoid deceitful brokers is to do your homework. And even then, the most thorough background check of the firm, broker or planner doesn't always prevent investors from falling prey to fraudulence.

Here we look at the most unscrupulous practices brokers have used to boost their commissions and push poor-quality investments onto unsuspecting investors.

Churning

Churning is the act of excessively trading a client's account. Some brokers with discretionary authority over an account use this unethical practice to increase their commissions. Churning is done to benefit the broker rather than the investor, as the only purpose of the trade is to increase commissions, not a client's wealth. In fact even one trade can be considered churning if it has no legitimate purpose. A warning sign of churning may be an unusual increase in transactions without any gains in a portfolio's value.

If you're truly worried that your account might be churned, you might want to consider a wrap account. This is an account by which a broker manages a portfolio in exchange for a flat fee. The advantage of a wrap is that it protects you from overtrading. Because the broker gets a flat annual fee, he or she only trades when it is advantageous to your portfolio. (For further reading, see *Wrap It Up: The Vocabulary And Benefits Of Managed Money*.)

Even if you've allowed your broker to trade for you, it is always prudent to keep up to date on what is going on in the portfolio. After all, it's your money!

Selling Dividends

When brokers try to convince a customer that purchasing a particular investment such as stocks or mutual funds will be profitable because of an upcoming dividend, this is referred to as dividend selling. In reality, the broker is trying to generate commissions through selling a client on a quick and easy gain.

Say, for example, that a company trading at $50 per share is about to offer a $1 dividend. A broker would be selling dividends if he or she told a client to hurry up and buy the stock to make a 5% return. In actuality, the client won't make this return at all. The stock price will instead decrease by $1 (the dividend) when it trades ex-dividend. In essence the investor gains little in the short term, and the move may make things worse if the dividend creates a tax liability for the investor. (For more insight about how dividends affect stocks, see *Dividend Facts You May Not Know*.)

This practice is also done in mutual funds: an advisor will tell a client to buy a fund because dividends are being paid out by companies in the fund. Just like the stock price above, the mutual fund's net asset value is discounted by the value of the dividend, resulting in a gain only for the broker - in the form of commissions. In fact, the investor is better off waiting until after the dividend offer: the stock will be at a lower price and the investor can avoid relatively higher taxes on the income from the dividend.

Withholding Recommendation to Invest at Breakpoint
Many brokerages and mutual fund companies have a sales charge on certain investments. It isn't that these sales charges are illegal, but sometimes the sales charges cause investors to pay more than they should. For example, let's say that a mutual fund company charges 5% for investments under $25,000 but only 4% for investments of $25,000 or more. A breakpoint sale would occur if you invest at $25,000 because at this amount your investment is in a lower sales-charge bracket.

However, to preserve their sales, unscrupulous advisors may recommended that you invest $24,750 into the fund even though you would save $250, or 1%, in sales charge by investing $25,000. Advisors may also keep you from reaping the benefits of breakpoints by splitting your money up among different investment companies, even though each company offers similar services. This leads to more commissions for the advisor and less cost savings to you as you are unable to take advantage of the lower commission rates when you reach the higher breakpoints. (For information on how to use breakpoints to your advantage, see *Break Free Of Fees With Mutual Fund Breakpoints*.)

Unsuitable Transactions
To sum up the nature of all these practices, we'd like to emphasize the meaning of "unsuitable transactions", a general term for investments made in a manner that is not consistent with the client's circumstances and/or investment objectives.You should know that your broker is duty-bound to know your financial needs (and constraints) and to make investment recommendations accordingly.

An example of a unsuitable transactions is double tax exemptions. Here is how they work: an investment advisor puts money whose gains are already protected from income tax, such as money in an IRA, into tax-free bonds or other securities. This is usually inappropriate because the investor does not need a tax-free investment, and such investments usually do not yield as much as other investments. The transaction is unsuitable because it does not fit the client's needs.

Other transactions that may be characterized as unsuitable include:

- High-risk investments if you have a low risk tolerance.
- Placing a high concentration of your money into one stock or security.
- Illiquid investments for those requiring easy access to funds.

Conclusion
It is important for all investors, regardless of their financial backgrounds, to maintain focus on their accounts. This does not mean that you need to review your account every day, but you should check in

regularly to stay on top of what's happening. If this is done along with a thorough examination of broker's investment proposals, you should avoid most types of broker fraud.

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