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Is the System Broke or Are Brokers Gaming the System?

by Allan G. King

Brokers who have been touting their market sophistication to their customers now are pleading ignorance of the competitive market forces that determine their own income.

In a spate of class action lawsuits against Merrill Lynch, Morgan Stanley, Prudential and other brokerages, filed principally in New York, securities brokers -- who earned billions in commissions annually -- now claim they were just hourly "wage earners," who were misclassified by their employers to thwart the Fair Labor Standards Act and the California Labor Code.

They seek unpaid overtime, or "backpay" -- using their prorated commissions (over a 40-hour work week) to calculate the "regular hourly rate" and demand 1 1/2 times this amount for all overtime hours. In other words, a broker who earned $400,000 last year, putting in 60-hour work weeks, made $200 per hour for a 40-hour work week (assuming 50 weeks per year). At time and a half for overtime, the employer owes this broker $300,000 per year. Under the FLSA, a court may double the amount of recovery when the violation at issue is "willful."

The irony of stockbrokers making such claims is undeniable: Brokers, as much as anyone, surely recognize that the labor market, like financial markets, responds to forces of supply and demand. These ensure that the particular method a brokerage adopts to compensate its brokers must net them pretty much the same income, whether calculated by the hour or by commission. In other words, if Merrill Lynch compensated its brokers by the hour, instead of by commission, the hourly wage would adjust to produce the same compensation that brokers receive under the prevailing system of commission payments. Emphatically, the broker who now earns $400,000 will not receive a $300,000 pay increase, at least not for long.

Stockbrokers, as surely as any group, know that such a substantial increase in compensation would have market consequences. Indeed, employers who previously were willing to pay $400,000 a year in commissions to these brokers would shed those who no longer earned their keep once pay jumped to $700,000. On the other side of the market, prospective brokers would flock to these employers to pursue these lucrative -- "above market" -- opportunities. The result? Under these pressures, broker compensation would descend back to the $400,000 level, notwithstanding that employers would be calculating this compensation at straight time plus overtime hourly rates.

The bottom line is that there is no economic injury to these brokers. Moreover, there is reason to suspect that, under this new payment regime, compensation would settle below $400,000. Under a commission structure, a broker's yearly compensation is uncertain, depending upon the broker's skill and the public's activity in the securities markets.

Under the new regime, brokers' incomes would depend merely on the time spent at work -- something much more within the broker's control than the number and volume of customer trades. Because market participants (in this case, the brokers themselves) value more predictable rewards, the certainty of an hourly wage may result in lower pay to brokers for the same work, compared to their previous commission system. The formula used to calculate backpay under

the FLSA and the California Labor Code ignores these market forces and therefore miscalculates any actual economic injury, which verges on zero.

In truth, the problem lies not with the brokers but with the statute. As Depression era legislation, the FLSA had two principal objectives. The first was to establish a minimum wage for working people; the second was to increase the number of jobs in the economy by spreading the available work among more workers. The overtime penalty was intended to accomplish this by creating an incentive for an employer to add more workers at a straight time rate, rather than paying premium overtime rates to fewer workers who labored longer hours. Because the overtime premium does not apply to exempt positions, the statute would have no teeth if employers could dodge the overtime requirement merely by declaring its employees to be "exempt."

However, the FLSA's remedial provisions have things backwards if its goal is to help those who remained unemployed because others worked overtime without being paid a premium. The injury that results from misclassifying employees as exempt, if any, affects those who are not working for this employer rather than those who are. It is the group that would have been employed that suffers because incumbents are misclassified, not the incumbents themselves. Yet, the statute provides a "remedy" for the incumbents who suffered no injury and denies relief to those without jobs.

Furthermore, the extent of the injury suffered by those who would have had jobs if incumbent employees were classified correctly is not even approximated by the backpay the statutes prescribe. The additional employment that would result depends on how sensitive the demand for this type of labor is to increases in hourly rates -- for example, the elasticity of labor demand. An industry in which demand is not very elastic would create just a marginal increase in employment if it paid overtime; thus the injury that results from violating the law may be marginal as well, notwithstanding the backpay calculation mandated by the FLSA and the Labor Code. In fact, it is highly unlikely that any penalty imposed by the FLSA for misclassifying employees fits the crime, and it's virtually certain that these amounts are paid to persons other than the true victims of the statutory violation.

If, in most cases, these employees suffer no economic injury, then the remedy prescribed by the overtime statutes are purely a penalty or fine to the employer and a windfall to these employees. Both the "due process" clauses of the Fifth and 14th Amendments and the "excessive fines" prohibition of the Eighth Amendment limit the penalties the government and private litigants can exact from defendants.

Although a constitutional defense to an overtime claim would be novel, the Merrill Lynch settlement suggests that brokerages and their attorneys may lack confidence in more conventional defenses. The rush to the courthouse suggests that plaintiffs attorneys may share that view. Perhaps the answer to these suits, which appear to have come from left field, is a legal attack that is similarly unconventional.