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The Dark Side of Broker-Dealer Scale

Having high staffing levels is no guarantee of high-quality service.

Larger broker-dealers consistently tout their scale as a reason to join them, because greater asset levels bring greater profitability, which enables them to bring more to advisors.

On the surface, this sounds logical. But when you do some digging, you discover some firms that can afford to give the most can be guilty at times of price gouging, cost cutting and conflict of interest with advisors wanting to adhere to a fiduciary standard.

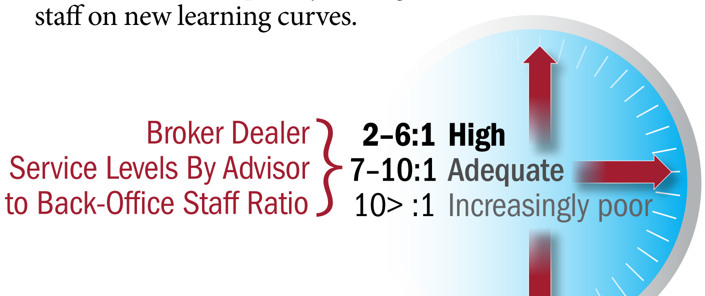
One of the greatest cost savings the larger firms don't talk about is labor.

You've probably seen a steady stream of news releases and promotional materials highlighting a broker-dealer's new "services." However, you rarely hear about service because that is often the weak link.

Having high staffing levels is not a guarantee that the service level always will be of high quality, although broker-dealers with consistent high-quality service do have high staffing levels—of around the 5:1 ratio of reps to staff.

Even with high advisor-to-staff ratios, these situations can detract from the service experience because:

- The broker-dealer has grown quickly and cannot keep up with staffing needs, so the back office is overwhelmed;
- The firm has obsolete operational technology;
- The BD lacks top-quality internal controls and processes;
- And there's a high turnover of back-office personnel, which leaves advisors frequently talking to staff on new learning curves.



Some large broker-dealers avoid the topic of service or staffing ratios. This is due to staffing ratios that can reach 10:1 or higher. This staffing level yields great cost savings to the broker-dealer, but advisors are the ones that suffer.

Whether it's back-office consolidation between a family of broker-dealers or team approaches, the results are the same: fewer staff to service advisor needs.

Here's a sampling of complaints we hear from advisors with such firms:

- "We call into a phone tree and often times are on hold for quite some time with callbacks hit and miss. It is rare that we connect with the same person twice."
- "The quality of the service desk is poor. Even with simple questions, they need to get back with me. What is especially alarming is when I get different answers from different people. What am I to believe?"
- "I've had to learn to be largely self-sufficient, so that I'm not reliant on the back office."
- "We hear a variety of heavy accents that we have trouble understanding in our communication, since the firm outsourced service to overseas companies."

Top-Quality Service for the Top Tier

Another tip-off to poor service is when a broker-dealer adds a layer of higher-quality service for their best producers.

In 2009, a larger BD was going to close their premier service desk for their top producers. We received several calls from advisors soon after the announcement; they wanted to leave because of this change.

Within two weeks, there was such outrage over the proposed premier service-desk closure that broker-dealer management did a 180-degree turn and decided to keep the service desk intact.

Without this higher service layer, top-producer retention likely would have plummeted. This logically leads to the question, "Why can't everyone at the firm get high-quality service?" (For a deeper dive into service research, see **"Evaluating Broker-Dealer Service."**)

Markups, Platform Fees on the Rise

Prevalent for over five years with larger firms, markups and platform fees are growing, with some midsize broker-dealers being tempted to go this route to expand profitability. Markups on third-party money managers' fees start as low as 2.5 basis points and go as high as 25 bps.

Many larger-broker dealers impose this markup, with one head of advisory at a large firm explaining to me, "If it is a smaller advisor with around $500K of production, we would mark up his managers' management fee 25 bps, while with larger producers we may only mark up 15 bps."

A common justification for this markup is to cover the cost of ongoing due diligence on the manager. Nice try! Historically, and today at most small and midsize broker-dealers, product due diligence is covered by the payout grid.

Platform fees are a newer trend, predominantly at larger firms, and are intended to level the profitability playing field.

If you want to custody advisory assets with a turnkey asset management platform held direct at the TAMP rather than through the broker-dealer's brokerage accounts, you could be charged a platform fee of 5 bps.

The broker-dealer makes more with the advisory assets held in a brokerage account than if they are held directly at the TAMP, which is the rationale for the charge of 5 bps.

Advisors that choose to custody advisory assets away (i.e, at an RIA custodian) like TD Ameritrade, Schwab or Fidelity IWS, may discover they're being charged a platform fee of 10 bps, because advisory assets are not custodied in a brokerage account.

Here again, assets held away from brokerage accounts are less profitable for the broker-dealer, so the charge of 10 bps fills the profitability gap.

Frequently, advisors choose to custody mutual fund and variable annuity assets direct with the product vendor, since this saves the client numerous costs imposed in a brokerage account, such as systematic deposit and withdrawal charges, dollar cost averaging charges, IRA custodial fees and inactive account fees.

One group of broker-dealers we are familiar with charges a small fee for holding these assets directly; it wouldn't surprise us if this were to become a new and expanding profit center to level the profitability playing field.

A Golden Goose

In 2011, when Mark Schlafly was CEO of FSC Securities, I spoke with him about how he introduced internally managed advisory platforms at FSC, which he had also implemented during his time at LPL Financial.

The narrative was compelling and included offering different platforms with different management styles (tactically managed, sector rotation, etc.). FSC would charge management fees under the industry average, and it simplified life for the advisor by having everything under one roof.

Internally, managed platforms have become a golden goose of profitability for broker-dealers. Today, we see them at many larger broker-dealers and a few midsize ones. The difference today is that broker-dealers are offering incentives to custody assets in their proprietary platforms, such as 100% payout or free Albridge consolidated client statements if you reach a certain asset threshold.

Advisors complain about these subtle and not-so-subtle tactics by broker-dealer management, wanting advisors to direct assets to these proprietary advisory platforms.

These tactics remind me of the 1990s, when insurance BDs would manipulate advisors to sell proprietary products via payout advantages, proprietary percentage requirements or restricted access to competing vendors.

Regulators put an end to these practices in the insurance sector to alleviate conflicts of interest. However, these tactics are fair game for proprietary advisory platforms, because they are not products per se but rather platforms that are not subject to the same scrutiny (yet).

Going Too Far?

With the pendulum at some independent broker-dealers swinging toward what is more in the broker-dealer's profitability interest and less on what is in the client's best interest, they inadvertently may be shooting themselves in the foot by make it increasingly difficult for those that adhere to a fiduciary standard to do what is in the client's best interest.

The greatest competition to the IBD channel is advisors going fee-only. Markups, platform fees and proprietary advisory platforms make it tougher to do what is in the client's best interest. This potentially increases the pace of advisors going RIA-only, especially in light of all certified financial planners being mandated to adhere to a fiduciary standard by the Financial Planning Association.

A New Certification Standard?

One person who points out these potential conflicts of interest is financial planner, speaker, blogger and educator **Michael Kitces**.

As he shared with me recently, "Advisors can try their best to withstand the pressures of the conflict of interest, and the outright financial incentive that may be dangled in front of them with differential payouts for using more profitable (for the broker dealer) in-house products. (And the fact that it's more profitable for the broker-dealer is in turn why they can offer financial incentives for their reps.)

"Extreme conflicts of interest in a true fiduciary environment are supposed to be mitigated (not made available in the form of proprietary advisory platforms) in the first place. Otherwise, it's almost inevitable that at least some reps may be tempted to cross the line," Kitces explained.

"The problem is that at least some broker-dealers are (completely legally, lacking an actual fiduciary standard) actively providing their advisors incentives to do what's best for the broker-dealer instead," he added.

Going forward, client costs will be more heavily scrutinized under the SEC's best-interest standard.

One way our industry could bring clarity to advisors looking for firms that are fiduciary-friendly is to have a certification standard for broker-dealers, such as FS for "fiduciary standard certified." The criteria could include having no markups on third party managers, no advisory platform fees and no proprietary advisory platforms, while being hybrid and dual-clearing friendly.

There are broker-dealers that fit this criteria. Perhaps such a certification could encourage broker-dealers to pursue client's best interests rather than the best transition note.

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